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T. C. Memo. 1986-405

UNITED STATES TAX COURT

DANIEL M. AND NANCEY N. KELLEY, Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 38523-84. Filed August 27, 1986.

Respondent determined a deficiency in petitioners' income taxes for 1980 based on items passed through from S corporation's return for its year ended Mar. 31, 1980. Notice of deficiency was sent after expiration of period of limitation on assessment of taxes against S corporation but prior to expiration of period for assessing taxes against petitioners. *Held*, the notice of deficiency was timely. The period of limitations applicable to petitioners controls assessment of the subject deficiency.

G.M/VL

Arthur H. Boelter, for the petitioners.

Michael R. McMahon, for the respondent.

MEMORANDUM OPINION

COHEN, Judge: Respondent determined a deficiency of $240,839 in petitioners' 1980 Federal income taxes. After concessions by both parties, the sole issue for decision is whether section 6501(a)[1] bars assessment of tax on an item reported on petitioners' 1980 tax return as their share of a small business corporation loss.

All of the facts have been stipulated. The facts set forth in the stipulation are incorporated by this reference and summarized below.

Petitioners Daniel M. Kelley (petitioner) and Nancey N. Kelley, husband and wife, resided in Tacoma, Washington, at the time their petition was filed. They timely filed a 1980 Federal income tax return. On that return, they deducted $163,933 as their share of the loss incurred by Holly Homes Company (Holly Homes) for its taxable year ended March 31, 1980.

At all relevant times, petitioner was a 50 percent shareholder in Holly Homes, a small business corporation under section 1371. Holly Homes timely filed Forms 1120-S, U.S. Income Tax Returns for an S Corporation, for its taxable years ended March 31, 1979, and March 31, 1980.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

Holly Homes executed a Form 872, Consent to Extend the Time to Assess Tax. The corporation's consent extended the period for assessment of any Federal income tax due for the taxable year ended March 31, 1979, to November 30, 1983. No additional extensions of the period of limitations were granted for the period described, and no extensions were executed for Holly Homes' taxable year ended March 31, 1980.

On November 30, 1983, petitioners executed a Form 872-A, Special Consent to Extend the Time to Assess Tax, extending indefinitely, but subject to specific means of termination, the period for assessment of any Federal income tax due for their taxable year ended December 31, 1980.

In his notice of deficiency dated August 14, 1984, respondent determined adjustments to petitioners' 1980 taxes in which he disallowed, among other things, $140,625 of the Holly Homes loss, which amount was attributable to a Holly Homes patent depreciation deduction.

Section 6501(a) generally provides that the amount of any tax imposed by the Internal Revenue Code shall be assessed within 3 years after the return was filed. The parties agree that, after applying the extensions described above, the notice of deficiency was within the statutory period for purposes of petitioners' 1980 tax return and not for purposes of Holly Homes' 1980 return.

Petitioners contend that the assessment of tax on them with respect to the Holly Homes loss is barred by section 6501.

Petitioners argue that the statute of limitations must be applied at the subchapter S corporation level, and therefore assessment of petitioners' 1980 tax regarding their share of the Holly Homes loss is barred. Respondent argues that the statute of limitations must be applied at the shareholder level, and therefore assessment is not barred.

Except as provided in section 1378 regarding certain capital gains, the shareholders of an electing small business corporation, and not the corporation, are liable for the income taxes due on the corporation's income. Sections 1372(b) and 1373(a). Because a valid S corporation is not liable for income taxes, there is no "amount" to be assessed under section 6501(a) and therefore no occasion for a period of limitations on assessment with respect to the corporation's return. Thus, the statute of limitations must be applied at the shareholder level.[2]

Section 6037 requires every electing small business corporation to file an information return for each taxable year. It also states that "[a]ny return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012." This language, petitioners argue, indicates that the statute of limitations must be applied to the S corporation's return. The quoted language, however, has been interpreted to mean that if the corporation is later determined not to be a small business corporation, the statute will run from its filing date for purposes of assessing tax on the corporation. See United States v. Adams Building Co., 531 F.2d 342, 343 n. 2 (6th Cir. 1976), citing Leonhart v. Commissioner, T.C. Memo. 1968-98, affd. per curiam on other issues 414 F.2d 749 (4th Cir. 1969). Moreover, this interpretation is consistent with the regulations and the legislative history of section 6037. Section 1.6037-1(c), Income Tax Regs., provides:

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[2] See Leonhart v. Commissioner, T.C. Memo. 1968-98, affd. per curiam on other issues 414 F.2d 749 (4th Cir. 1969).

> (c) Other provisions. The return on Form 1120-S will be treated as a return filed by the corporation under section 6012, relating to persons required to make returns of income, for purposes of the provisions of chapter 66 of the Code, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, chapter 1 of the Code, will run from the date of filing the return under section 6037, or from the date prescribed for filing such return, whichever is the later.

See S. Rept. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 1147.

Petitioners postulate additional arguments on the basis of the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669. This Act, however, is effective for taxable years beginning after December 31, 1982, and therefore does not apply to petitioners' year in issue. Section 6 of the Subchapter S Revision Act of 1982.

Petitioners also argue that the statute of limitations should be applied at the S corporation level because an S corporation is a legal entity with its own separate identity, because an S corporation is similar to a subchapter C corporation, and because it would result in fair and consistent treatment of all shareholders. After due consideration, we conclude that these arguments are unpersuasive and inconsistent with the corporation's special status under subchapter S as a nontaxable entity for Federal income tax purposes. We hold that assessment of petitioners' 1980 taxes is not barred by the statute of limitations.

Petitioners requested reasonable attorneys' fees and litigation costs in their petition. Petitioners have not prevailed. Moreover, such a claim shall not be included in the petition. Rule 34, Tax Court Rules of Practice and Procedure.

By Amendment to Petition, petitioners claim a carryback of a 1982 net operating loss to the year in issue. To properly compute the amount of the deficiency,

Decision will be entered
under Rule 155.

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T. C. Memo. 1986-406

UNITED STATES TAX COURT

LAMBERT M. WARE, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 16383-81. Filed August 27, 1986.

Gregory L. Williams and *John E. Cicero II*, for the petitioner.

Jane T. Dickinson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

C.M/VL

Year	Deficiency	Sec. 6653(a)[1] Addition to Tax
1977	$23,406.20	----
1978	26,218.47	$1,310.92

After numerous concessions by both parties, the following issues remain for decision:

(1) Whether petitioner is entitled to certain rental expenses and rental depreciation deductions with respect to a personal residence;

(2) Whether petitioner is entitled to employee business expense deductions in connection with his professional status as a harbor ship pilot;

(3) Whether petitioner is entitled to a business expense deduction in 1978 for wages allegedly paid to his driver;

(4) Whether petitioner is entitled to a new jobs credit for an individual he claims to have hired as his driver in 1978;

(5) Whether depreciation deductions should be allowed with regard to certain items of personal property that petitioner claims to have used in his trade or business;

(6) Whether an investment tax credit should be allowed for certain tangible personal property placed in service by petitioner in 1977;

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

(7) Whether petitioner is entitled to a deduction for certain amounts allegedly expended for tax planning and return preparation; and

(8) Whether petitioner is liable for the addition to tax pursuant to section 6653(a) for 1978.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference.

Lambert M. Ware (hereinafter petitioner) resided in Tampa, Florida, when he filed his petition in this case.

In July 1975, petitioner and his wife, Dorothea, acquired residential property located on White Trout Lane (White Trout) from William E. and Marilyn B. Gatlin. Before purchasing the White Trout residence, petitioner and Dorothea entered into an agreement which provided that any asset that they purchased jointly would be held by them in proportion to the relative amounts each had invested. On December 22, 1976, petitioner and Dorothea Ware were divorced. In January 1977, petitioner purchased Dorothea's ownership interest in White Trout by executing a promissory note to her for $21,000. The purchase price reflected Dorothea's original investment of $10,000, plus $11,000 in appreciation. In December 1977, petitioner gave his former wife a mortgage on White Trout in the amount of $21,000 to serve as security for his promissory note. On December 30, 1977, Dorothea's ownership interest in the property was conveyed to petitioner by way of a quitclaim deed recorded on January 24, 1978.

Pursuant to the terms of a lease executed December 30, 1977, but made retroactive to January 1, 1977, Dorothea was to lease White Trout for a 6-year period at a fixed rate of $650 per month. Despite the 6-year term provided for by the lease, Dorothea only occupied the residence until July 15, 1978. Although petitioner initially leased the house to Dorothea in a furnished condition, the lease was modified to provide that as of February 1, 1978, White Trout would be rented in an unfurnished condition for $500 per month.

During 1977 and 1978, petitioner made first and second mortgage payments (including principal and interest) on the White Trout property of $587 per month and $375.28 per month, respectively. Additionally, petitioner paid for all expenses associated with the residence during 1977 and 1978, although he was not required by the express terms of the lease to pay for expenses other than for major repairs.

On his 1977 and 1978 Federal income tax returns, petitioner reported as income the rental payments he received from Dorothea. He deducted rental income expenses associated with White Trout in the amount of $12,809 in 1977 and $3,292 in 1978. Petitioner also claimed depreciation deductions totaling $8,904 in 1977 and $9,111 in 1978. The assets that petitioner sought to depreciate included the house, certain appliances, the cost of a new roof, and the furnishings associated with the White Trout residence. Respondent disallowed the rental expense and the depreciation deductions for both years because, as determined by respondent, petitioner did not hold the White Trout property for the production of income.

During the years in issue, petitioner was a Tampa Bay harbor pilot who was required to be on call 24 hours a day for approximately 180 days per year. Ships coming in and out of the port area around Tampa Bay must be piloted by someone familiar with the region. Each pilot employed in the Tampa Bay area, including petitioner, is a partner in the Tampa Bay Pilot Association. Ships entering and leaving Tampa Bay routinely contact the Association's radio dispatcher when they require navigation in or out of port.

The Association maintains a facility on an island called Egmont Key, where there is a radio dispatching room and several small power boats. As a member of the Association, petitioner is required to own and personally maintain a small cottage on Egmont Key. The cottage was used by petitioner solely for business purposes and served as a place to rest between job duties while remaining at a location close to where petitioner's subsequent assignments would originate. The Association required petitioner to be accessible during the entire 24-hour period that he was on call. In addition, because petitioner's job assignments during the years in question took him to many locations in the Tampa Bay area at varied times, he often made arrangements for a driver to pick him up and transport him to his next assignment. Petitioner employed Nancy Jo Midulla (Midulla) in the latter half of 1978 primarily as his driver. Midulla also performed some incidental bookkeeping services.

On his 1977 and 1978 Federal income tax returns, petitioner claimed the following business expense deductions:

	1977	1978
Answering Service, telephone and remote pager (beeper)	$1,092	$1,556
Egmont Key cottage maintenance, utilities and telephone	312	2,326
Payroll (driver) - wages		6,213
Payroll (driver) - taxes		587
	$1,404	$10,682

These deductions were disallowed because, according to respondent, petitioner failed to show that they were ordinary and necessary business expenses within the meaning of section 162. Respondent also determined that petitioner failed to provide adequate substantiation for the claimed expenditures.

Petitioner claimed a tax credit for a new employee pursuant to section 44B. The new jobs credit was disallowed by respondent because petitioner failed to establish the extent to which he paid for services rendered to him in the course of his trade or business.

In 1977, petitioner purchased two automobiles, a telephone recording device, an air conditioner, and a lawn mower. Petitioner claimed both depreciation and investment tax credits alleging that these items constitute tangible property used in his trade or business. The parties agree that petitioner is entitled to a depreciation deduction in each year equal to 12.5 percent of the bases of the automobiles, or $1,960.60 per year for 1977 and 1978. The depreciation deductions and the investment tax credit for the telephone recording device, the air conditioner, and the lawn mower remain at issue. Because the percentage of automobile use attributable to petitioner's trade or business is 12.5 percent, petitioner concedes that he is only entitled to an investment tax credit based on such business use.

Petitioner claimed deductions for tax planning and return preparation services on his 1977 and 1978 returns in the amounts of $3,001 and $4,000, respectively. Petitioner alleges that the above amounts are deductible pursuant to section 212(3) as ordinary and necessary expenses paid or incurred with regard to the determination, collection, or refund of any tax. Respondent disallowed these deductions on the ground that petitioner's claimed deductions were not shown to be expenditures made solely with regard to the preparation of petitioner's 1977 and 1978 income tax returns.

Finally, respondent determined that petitioner is liable for the addition to tax pursuant to section 6653(a) for 1978. Petitioner employed a certified public accountant to prepare his

1978 Federal income tax return. He relied exclusively on his accountant's tax counseling and advice. Petitioner was unsophisticated in tax matters and had to completely depend on his accountant to advise him regarding the tax consequences of the transactions at issue.

OPINION

I. White Trout Rental Expenses and Depreciation

Respondent argues that petitioner is not entitled to depreciation deductions pursuant to section 167 or maintenance expense deductions pursuant to section 212(2) because petitioner did not hold the White Trout residence with a profit objective within the meaning of section 183.

We agree with respondent. Petitioner acquired the property in 1975 with his wife, Dorothea Hover. Dorothea and petitioner were divorced in December 1976 and, pursuant to a lease executed on December 30, 1977, but made retroactive to January 1, 1977, Dorothea was to lease the residence from petitioner. Although the lease specified that the house would be rented with furnishings for a 6-year period at the rate of $650 per month, Dorthea remained in the residence only until July 15, 1978. The agreement was subsequently modified effective February 1, 1978 to provide that the residence would be rented in an unfurnished condition for $500 per month.

If an activity is not engaged in for profit, section 183 allows deductions for ordinary and necessary expenses arising from the activity only to the extent of the gross income derived from the activity, less those deductions (such as mortgage interest and real estate taxes) which are allowable in any event. Sutton v. Commissioner, 84 T.C. 210, 221, 222 (1985).[2] The absence of a profit is not itself determinative, but the activity must be of such a nature that the taxpayer's profit objective is bona fide. Dreicer v. Commissioner, 78 T.C. 642, 644-645 (1982), affd. without opinion 702 F.2d 1204 (D.C. Cir. 1983).

Section 1.183-2(b), Income Tax Regs., sets forth nine separate factors to be considered in determining whether an activity is "not engaged in for profit." The factors are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. We will consider each factor in the order listed.

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[2] Sec. 183 provides in relevant part as follows:

> SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.
> (a) General Rule.--In the case of an activity engaged in by an individual * * * , if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(1) The manner in which the taxpayer carries on the activity - The fact that a taxpayer carries on an activity in a businesslike manner and maintains complete books and records may indicate that the activity was engaged in for profit. No evidence exists in the instant case to indicate that petitioner took even the most rudimentary steps to lease White Trout in a profitable manner.

No evidence was presented regarding the fair rental value of the White Trout residence. We do note, however, that the lease agreement entered into between petitioner and Dorothea appears to have been significantly influenced by their recent divorce and property settlement. The failure to lease property at fair rental value is a strong indication that the taxpayer did not have a bona fide profit objective. Jasionowski v. Commissioner, 66 T.C. 312, 322 (1976). Petitioner indicated in his amended answers to interrogatories that his former wife Dorothea would testify as to the nature of the lease agreement, but she was never called as a witness. The natural inference to be drawn from Dorothea's failure to testify is that her testimony would not have been favorable to petitioner. Pollack v. Commissioner, 47 T.C. 92 (1966), affd. 392 F.2d 409 (5th Cir. 1968).

Petitioner failed to offer any evidence to indicate that he had in any way advertised the property for rent or that he had sought tenants other than his former wife for the White Trout residence. In addition, petitioner's obligations relative to the first and second mortgages on the White Trout property were well in excess of the rental income. Furthermore, petitioner paid for all improvements made to the residence as well as certain maintenance expenses not required under the express terms of the lease. In short, the evidence in the record does not establish that petitioner conducted the rental of White Trout in a businesslike manner.

(2) The expertise of the taxpayer or his professional advisors - The record does not indicate that petitioner prepared for the activity by a study or survey of accepted rental practices. As respondent points out, the circumstances surrounding the lease between petitioner and Dorothea make it appear to be more in the nature of a property settlement. In addition, there is no indication that petitioner sought expert advice in this matter.

(3) The time and effort expended by the taxpayer in carrying on the activity - Petitioner presented no evidence to indicate that he devoted significant time and effort to conducting the rental activity.

(4) Expectation that assets utilized in the activity will appreciate in value - The evidence in the record does establish that the White Trout residence was appreciating in value during

the years in issue. Petitioner argues that although he failed to show a profit initially, the fact that he leased the residence to his former wife while the property was appreciating is suggestive of a profit objective on his part. Anticipated appreciation in the value of residential property is certainly a relevant factor, but it is not alone determinative. "[I]f the anticipation of eventually selling the house at a profit were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim." Jasionowski v. Commissioner, supra at 323. (Citations omitted.)[3]

(5) The success of the taxpayer in carrying on other similar or dissimilar activities - Petitioner has not shown that he has been engaged in any other rental activities, successful or otherwise, in the past.

(6) The taxpayer's history of income or losses with regard to the activity - The regulations indicate that a series of losses in the initial stages of an activity may not necessarily show that the activity was not engaged in for profit. Section 1.183-2(b)(6), Income Tax Regs., goes on to provide, however, that where the losses continue beyond the period that is generally necessary to bring the endeavor into a profit making mode, such losses may indicate that the activity is not being

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[3] Cf. Nicath Realty Co., Inc. v. Commissioner, T.C. Memo. 1966-246.

engaged in for profit. Petitioner offered no evidence to suggest that the alleged conversion of his personal residence to a rental income producing property involved major nonrecurrent start-up expenses. Even if we were to ignore the monies expended by petitioner for real estate taxes, maintenance and improvements, the amount that he was obligated to pay with regard to his first and second mortgages on the White Trout residence were alone sufficient to totally negate any potential profit from the activity.

(7) The amount of occasional profits, if any, which are earned - The regulations provide that substantial profits, though at infrequent intervals, could be indicative of a profit motive. In addition, a profit motive can be found to exist where petitioner has an opportunity to earn a very substantial gain from a highly speculative activity. Section 1.183-2(b)(7), Income Tax Regs. Neither of the above factual scenarios, however, are analogous to the set of circumstances present in this case. Petitioner did not realize any profit from his activities, frequent or otherwise. Additionally, the conversion of residential property into income producing rental property is not generally viewed as a highly speculative activity.

(8) The financial status of the taxpayer - Section 1.183-2(b)(8), Income Tax Regs., indicates that a profit motive may be discerned where a taxpayer does not have substantial income from sources other than the activity in question. It is quite evident

that petitioner's primary source of income in 1977 and 1978 came from his activities as a harbor pilot in the Tampa Bay area and not from his rental activities.

(9) Elements of personal pleasure or recreation - The regulations imply that the presence of personal motives associated with engaging in an activity may be an indication that the activity was not engaged in for profit. We recognize that the White Trout property did not provide petitioner with the type of recreational enjoyment or satisfaction that would often be associated with a vacation home. However, the evidence strongly suggests that petitioner's personal obligations may have played a major role in both the determination of the amount of rent charged, and petitioner's willingness to assume responsibility for all maintenance and improvements associated with the property. We think the circumstances surrounding the lease indicate that the contractual arrangement struck between petitioner and his former wife was flavored by their recent divorce and was not entered into with the primary purpose and objective of making a profit.

Petitioner has failed to carry his burden of proof with respect to establishing that his rental of the White Trout residence to Dorothea in 1977 and part of 1978 qualified as an activity engaged in for profit. In addition, his testimony that a third party had leased a portion of the home in the latter part of 1978 was uncorroborated. Petitioner had indicated both in his amended answers to interrogatories and in his trial memorandum that Mr. Ralph Schumaker would testify that he leased a portion of the residence in 1978. No explanation was given for the absence of this witness at the trial and we therefore can infer that Mr. Schumaker's testimony would not have been favorable to petitioner. "The burden of proof is upon [petitioner] and we cannot assume that the missing evidence would have been favorable to [him]." *Kamborian v. Commissioner*, 56 T.C. 847, 869 (1971), affd. 469 F.2d 219 (1st Cir. 1972).

II. Employee Business Expenses

A. Expenses Incurred With Regard to Petitioner's Pilot Station Cottage on Egmont Key

Petitioner is a harbor pilot and a partner in the Tampa Bay Pilot Association. Ships coming in and out of the port area around Tampa Bay routinely contact the Pilot Association's dispatching unit at Egmont Key. Captain Cyrus Epler, another Tampa Bay pilot, testified that each pilot is required to own and maintain a cottage on Egmont Key as a condition of membership in the Association. Captain Epler also testified that the expenses associated with building and maintaining the island cottage are solely the responsibility of the individual harbor pilot.

On his 1977 and 1978 Federal income tax returns, petitioner claimed deductions pursuant to section 162[4] in amounts totaling $312 and $2,326, respectively, for utility and maintenance expenses relating to petitioner's cottage on Egmont Key. Respondent disallowed these deductions in part because they were personal in nature and in part because they were not adequately substantiated.

Section 162 allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year. Section 262,[5] in contrast, prohibits a deduction for personal, living, or family expenses even if otherwise related to one's occupation. The deduction claimed by petitioner in 1977 consists exclusively of utility expenses associated with the Egmont Key cottage. The 1978 deduction claimed by petitioner includes expenses incurred for items that petitioner claims to have purchased for use in his cottage.

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[4] Sec. 162 provides in relevant part as follows:

> SEC. 162. TRADE OR BUSINESS EXPENSES.
> (a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

[5] Sec. 262 provides as follows:

> SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES,
> Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

In Cooper v. Commissioner, 67 T.C. 870 (1977), affd. sub nom. Sibla v. Commissioner, 611 F.2d 1260 (9th Cir. 1980), a fire department employee was required, as a condition of his employment, to participate in an organized meal plan at his duty post. The employee was assessed an amount equal to his portion of the total food cost for each 24-hour shift that he worked. This Court allowed the fire department employee a deduction pursuant to section 162 equal to the amount he was required to contribute. According to the Court of Appeals, "that which may be a personal expense under some circumstances can, when circumscribed by company regulations, directives, and conditions, lose its character as a personal expense and take on the color of a business expense." Sibla v. Commissioner, supra at 1262.

It is well established that a taxpayer may be in the trade or business of being an employee. Primuth v. Commissioner, 54 T.C. 374 (1970). Much like the taxpayer in Cooper v. Commissioner, supra, petitioner in the instant case was required, as a condition of his employment, to own and maintain a cottage on the island of Egmont Key. Respondent argues, however, that the cottage expenses constitute personal expenses nondeductible under section 262. The expenditures incurred by petitioner in the years in issue possess a blend of both personal and business attributes. In such a situation, this Court has held that "placement of that often thin line which distinguishes a 'personal expense' from a 'business expense' depends primarily upon the facts and circumstances of each particular case."

Cooper v. Commissioner, 67 T.C. at 873. According to respondent, otherwise nondeductible personal expenses may in fact qualify for deduction under certain circumstances. See Rev. Rul. 75-316, 1975-2 C.B. 54.

During the years in issue, petitioner was a harbor pilot in the Tampa Bay area and was required, as a condition of his employment, to own and maintain a cottage on a remote island. During 1977 and 1978, petitioner was on call 24 hours a day, 180 days each year, and the cottage served as a necessary haven for on-call pilots to rest between job duties while remaining at a location close to where their subsequent assignments would originate. The cottage is, in this sense, the functional equivalent of the fire station in Cooper v. Commissioner, supra, in that its purpose is solely to provide petitioner with a place to eat and sleep while awaiting the next job assignment. In addition, the cottages owned and maintained by the harbor pilots are not used for personal or recreational endeavors.

Because of the unusual nature of the petitioner's employment, the involuntary nature of the expenses incurred and the Pilot Association's refusal to reimburse petitioner for the expenses he incurred with regard to the cottage, we find that the amounts in issue constitute ordinary and necessary business expenses. Having reached this conclusion, we must now turn to the issue of whether petitioner has adequately substantiated his 1977 and 1978 expenditures for the deduction in question.[6]

Deductions are provided as a matter of legislative grace and the taxpayer has the burden of proving his entitlement to them. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). The taxpayer's testimony alone is not always sufficient to satisfy this burden of proof. Petitioner has provided the Court with receipts and canceled checks to substantiate some of the deductions claimed with regard to his cottage. Although the documentation proffered with regard to the 1977 and 1978 expenses is incomplete, petitioner argues on brief that we should allow the claimed deductions by applying the approximation rule set forth in Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

Although this Court has utilized the Cohan rule on many different occasions, it is not automatic and the taxpayer must bring himself within its scope in order to benefit from its application. A deduction will be allowed based on an approximation only if the tribunal is convinced that deductible expenses have in fact been incurred. There must be "sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose." Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957). (Emphasis in original.) According to the rule laid down by Judge Learned Hand in Cohan v. Commissioner, supra, the court should "make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." Cohan v. Commissioner, supra at 544. The Cohan rule provides the taxpayer with some relief where he incurs deductible expenses but cannot prove their exact amount. Mayrath v. Commissioner, 357 F.2d 209, 214 (5th Cir. 1966), affg. 41 T.C. 582 (1964).[7]

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[6] In Vanicek v. Commissioner, 85 T.C. 731, 742, 743 (1985), we disallowed deductions for certain expenses incurred by petitioner in operating and maintaining lodgings furnished by his employer. The deductions were disallowed because petitioner failed to provide this Court with any evidence from which we could reasonably apportion the expenses between the business and personal use of the residence. The Vanicek case is distinguishable however, because petitioner in the instant case used the Egmont Key cottage solely for business purposes. Thus, no allocation between business and nonbusiness use is required. Petitioner maintained a residence, separate and apart from the Egmont Key cottage, which he used for personal purposes.

Petitioner claimed a deduction in 1977 for utility expenses totaling $312, but failed to provide any documentation to substantiate these expenditures. Although petitioner's only corroboration consisted of his testimony which was vague, we think that an approximation is warranted under the Cohan rule because we are satisfied that the Egmont Key cottage was used for business purposes and that utility expenses were necessarily incurred. We will allow petitioner a deduction for the taxable year 1977 equal to 50 percent of the amount claimed for utility expenses.

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[7] See also Stemkowski v. Commissioner, 82 T.C. 854, 867 (1984); Epp v. Commissioner, 78 T.C. 801, 807 (1982); Merighi v. Commissioner, T.C. Memo. 1981-717; Afshar v. Commissioner, T.C. Memo. 1981-241, affd. without published opinion 692 F.2d 751 (4th Cir. 1982); Shields v. Commissioner, T.C. Memo. 1978-120, affd. without published opinion 644 F.2d 889 (9th Cir. 1981).

Petitioner also claimed deductions for expenditures relating to his cottage at Egmont Key totaling $2,326 in 1978. Although the schedules and the testimony of petitioner are incomplete, we are convinced from the record that deductible expenses were in fact incurred by him. We therefore allow petitioner a deduction in 1978 of $714.92 to reflect the cottage expenditures that were substantiated in a manner that allowed this Court to ascertain the amount and date of each expenditure and the identity of same.[8] In addition, we will permit a deduction for the expenditures incurred by petitioner with regard to the telephone that he maintained at the Egmont Key cottage. Although petitioner is claiming that he incurred $253.11 in expenses with regard to the maintenance of this telephone, we can find substantiation for only $189.54 of that amount. In addition, the documentation provided by petitioner shows substantial charges for long distance telephone calls which we are not persuaded represent only business calls. We believe that an approximation is justified under the Cohan rule. We will allow petitioner a deduction for the taxable year 1978 equal to 50 percent of the amount substantiated, or $94.77.

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[8] We note that respondent argued that petitioner's cottage expenditures should be disallowed because they are personal in nature or, alternatively, because they were not substantiated. Respondent did not argue that any of these expenditures are capital in nature and therefore not currently deductible by virtue of sec. 263.

B. Telephone Expenses

We turn next to petitioner's claimed deductions for beeper, additional telephone, and telephone answering service expenditures. He claims that such expenditures were ordinary and necessary in his trade or business because, as a harbor pilot, he is required to remain available to receive job assignments by telephone from the Pilot Association. Petitioner testified that he was required to remain in contact at all times during each 24-hour period that he was on call during the years in issue. He also testified that he would be fined if he could not be contacted by the dispatcher while on duty. Respondent agrees that the beeper expenses qualify as ordinary and necessary pursuant to section 162. Petitioner has provided the Court with testimony and corroborating documentation for beeper expenditures in the amounts of $538.56 and $283.28 for 1977 and 1978, respectively. A deduction will be allowed to this extent pursuant to section 162.

Respondent contends that petitioner did not adequately demonstrate that his claimed deductions for answering service and telephone charges had a sufficient business nexus. Petitioner claimed deductions in 1977 and 1978 for answering service, beeper and telephone expenditures totaling $1,092 and $1,556, respectively. Respondent cites Levine v. Commissioner, T.C.

Memo. 1983-342, wherein this Court disallowed a taxpayer's deduction for telephone expenses. In that case, the taxpayer was a social worker who was required to carry a beeper. Respondent asserts that because petitioner wears such a device, his expenses for his telephone and answering service are personal in nature. Petitioner argues, however, that because of the unique nature of his trade or business, a beeper is often not adequate. For instance, petitioner has no access to a telephone while piloting a ship and therefore he had to call his answering service to obtain his next job assignment after reaching port.

In Roth v. Commissioner, 17 T.C. 1450 (1952), this Court allowed a deduction for the cost petitioner incurred in maintaining a telephone because the telephone was not used for personal purposes. We held that the expenses relating to the telephone were "so closely and directly related to petitioner's earning of income and reasonably necessary in the course of his employment as to qualify as a deductible expense." Roth v. Commissioner, supra at 1455. The taxpayer in Roth was a fireman who was required, much like petitioner, to remain in communication with his employer while on duty.[9] Thus, the expenses incurred in maintaining a telephone are deductible, provided that the cost incurred thereby is directly related to the taxpayer's trade or business.

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[9] See also Banks v. Commissioner, T.C. Memo. 1981-490, where this Court applied the Cohan rule to allow a fireman a percentage of the expenses he incurred in maintaining a telephone. The taxpayer, much like petitioner in the instant case, was required to be on call 24 hours a day. Although it was not mandatory that he maintain a telephone, he was required to remain within verbal communication within these on call periods.

Petitioner and Captain Epler both gave credible testimony as to the unique nature of their business and the necessity for maintaining adequate communication with the Pilot Association's dispatcher while on duty. We further recognize that a beeper is not alone sufficient to meet this need due to the frequent and extended periods during which petitioner is piloting ships. Petitioner has provided testimony and corroborating documentation for answering service expenditures during 1977 and 1978 of $527 and $555.58, respectively. Thus, a deduction pursuant to section 162 will be allowed in such amounts.

Petitioner's documentation for his base telephone charges indicates six different telephone numbers. According to his testimony, one telephone number (883-7126) was associated with his electronic beeper. Thus, as we noted above, the base telephone charges incurred by petitioner with regard to this number are deductible as a business expense pursuant to section 162. In addition, petitioner testified that 821-3725 represents the number for the telephone used at the Egmont Key cottage. As discussed above, a portion of the base charges incurred with regard to this telephone number are deductible pursuant to section 162. Petitioner, however, was unable to show the extent to which the base telephone charges relating to the remaining four numbers (823-7651, 238-3443, 935-4658, and 935-8166) were business related. Additionally, the photo copies of the telephone invoices submitted by petitioner regarding certain of these telephone numbers indicate monthly charges for long distance calls which we are not persuaded were business-related. Thus, no deduction will be allowed with regard to petitioner's base telephone charges for these remaining four telephone numbers.

C. Payroll Expenditures for Petitioner's Employee

Petitioner argues that when he is on duty he needs transportation between his job assignments. He employed Nancy Jo Midulla (Midulla) in the latter half of 1978 primarily as his driver. Petitioner indicated that Midulla also performed some incidental bookkeeping services. On his 1978 Federal income tax return, petitioner deducted payroll expenses of $6,213 and taxes of $587.

Section 162(a)(1) provides for "a reasonable allowance for salaries or other compensation for personal services actually rendered."[10] Before reaching the question concerning the reasonableness of the compensation, we must first deal with the threshold issue of whether petitioner actually received the benefit of any personal services from Midulla in 1978.

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[10] We note that respondent has apparently conceded that petitioner's transportation between job assignments did not involve nondeductible commuting expenses. See Steinhort v. Commissioner, 335 F.2d 496, (5th Cir. 1964), affg. and remanding a Memorandum Opinion of this Court.

Although petitioner has provided copies of canceled checks payable to Midulla in amounts of $700, $300, $800, $1,500, and $1,000, it is not possible to determine the job assignments for which petitioner actually used his driver. Janet Makinen testified that she dated petitioner during part of the period during which Midulla was allegedly employed. Ms. Makinen indicated that she would often pick petitioner up from different parts of the Tampa Bay area during the period in question. The canceled checks submitted by petitioner in support of his claimed deduction indicate that payments totaling $4,300 were made to Midulla. However, petitioner's own testimony indicates that some of these payments were in fact made to a third party in connection with the painting of petitioner's house. In addition, respondent notes that some of the checks payable to Midulla appear to have been tendered for services that had not yet been performed. Specifically, the check dated November 7, 1978, indicates that it was for wages for the month of November in the amount of $1,000, and for one-half of October in the amount of $500. Obviously the nature of petitioner's business is such that he would not have known of his transportation needs in advance. Finally, it is well-established that the expenses petitioner incurred in traveling from his home to his first assignment or to the Association's facility on Egmont Key, and from his last place of work to home constitute nondeductible commuting expenses. Steinhort v. Commissioner, 335 F.2d 496 (5th Cir. 1964), affg. and remanding a Memorandum Opinion of this Court.

We believe that a small portion of the amount in question in fact consists of amounts paid by petitioner to Midulla for the services she rendered as his driver. Petitioner, however, has failed to provide any itemization to reflect the amounts paid for each trip. In addition, he admits that at least a portion of the amount in dispute was paid to Midulla to compensate her brother for painting petitioner's residence.

Petitioner testified that he did not recall the method by which he calculated the wages paid to his driver but that generally he would pay $5, $10, $15, or $20 for a single trip. A summary of petitioner's duty roster for the last six months of 1978 shows only 126 entries. We believe that a substantial number of these trips constitute commuting and the expenses associated with such trips are nondeductible. Steinhort v. Commissioner, supra. This Court has often permitted deductions based on estimates where the taxpayer is unable to substantiate his expense deductions. Cohan v. Commissioner, supra. In making our approximation, we bear heavily against petitioner whose inexactitude is of his own making. We think that a deduction equal to $630 is reasonable reflecting an allowance of $10 for one-half of the 126 trip entries during the later half of 1978. A deduction will be allowed to that extent.

As to a related matter, petitioner also claimed a new jobs credit in 1978 pursuant to section 44B for the wages paid to Midulla. Section 44B provides the taxpayer with a tax credit if he employs certain categories of new workers. The provisions describing the mechanics of the new jobs credit are found in sections 51 through 53. Section 51(g)(1) provides that "[r]emuneration paid by an employer to an employee during any calendar year shall be taken into account only if more than one-half of the remuneration so paid is for services performed in the United States in a trade or business of the employer." As stated above, petitioner did not satisfactorily establish that at least one-half of the amounts paid to Midulla were paid with regard to services she performed for petitioner in his trade or business, and, for this reason, we disallow the claim for the new jobs credit.

D. Depreciation Deductions and Investment Tax Credit with Regard to Tangible Personal Property Used in Petitioner's Trade or Business

In 1977 and 1978, petitioner claimed depreciation deductions for certain items of tangible personal property that he asserts were used in his trade or business. The items in question include two automobiles, a telephone recording device (Code-a-phone), an air conditioner, and a lawn mower. As to the two automobiles, the parties have agreed that petitioner is entitled to a depreciation deduction for both years equal to 12.5 percent of the stipulated bases, or $1,960.60 per year. Still at issue is whether petitioner should be allowed a depreciation deduction for the Code-a-phone, the air conditioner, and the lawn mower.

Section 167(a)(1) provides for the allowance of a depreciation deduction with regard to property used in the taxpayer's trade or business. We have already determined that petitioner's profession demands that he remain in constant contact with the Pilot Association while he is on duty. Petitioner provided credible testimony to corroborate both the fact that he purchased the telephone recording device in 1977 and the amount that he paid. He also testified that the telephone answering machine was used exclusively in his trade or business. According to petitioner, the device was used to record messages to insure that he received his job assignments in a timely fashion. Accordingly, we find that the recording device constitutes "property used in the trade or business," thereby entitling petitioner to a depreciation deduction pursuant to section 167(a).

We have already determined that the expenses associated with the ownership and maintenance of the cottage constitute ordinary and necessary business expenses deductible under section 162(a). The purchase of a lawn mower and air conditioner are generally personal expenditures which are ordinarily nondeductible under section 262. We note, however, that many expenditures possess both personal and business attributes. The fact that a particular expense may under certain circumstances be a nondeductible personal expense does not preclude the deduction of such an expense as an ordinary and necessary business expense under other circumstances. Cooper v. Commissioner, 67 T.C. 870 (1977), affd. sub nom. Sibla v. Commissioner, 611 F.2d 1260 (9th Cir. 1980).

In the instant case, petitioner is a harbor pilot who is required by the Pilot Association to own and maintain a cottage on an island. We find from petitioner's own testimony that both the lawn mower and the air conditioner were purchased and placed in service in 1977 for use exclusively at his cottage on Egmont Key. In addition, the requirement that petitioner own and maintain the cottage was implemented by the Pilot Association in order that he would be more accessible while on duty. Thus, from a practical standpoint, the purchases in issue were a matter of business necessity on the part of both petitioner and his employer. Therefore, we hold that the air conditioner and the lawn mower qualify as "property used in the trade or business" entitling petitioner to depreciation deductions for the years in issue.

In 1977, petitioner claimed an investment tax credit for the same items of tangible personal property for which he took depreciation deductions in 1977 and 1978 (two automobiles, the telephone recording device, an air conditioner, and a lawn mower). He testified that all of these items were placed in service in 1977. In addition, the parties stipulated that the percentage of automobile use attributable to the petitioner's trade or business is 12.5 percent for both 1977 and 1978. Thus, petitioner concedes that he is entitled to an investment tax credit based only on such business use. The parties now concur that the investment tax credit for both cars should be computed by using a purchase price of $9,612 and $6,072.76 for the 1978 Chevrolet and the 1977 Toyota, respectively. The parties also agreed that the purchase prices for the telephone recording device, the air conditioner, and the lawn mower total $1,039 for purposes of the investment tax credit.

A taxpayer is allowed an investment tax credit when he purchases certain tangible personal business property. Sections 38 and 48(a). To qualify for the credit, the property acquired must constitute "section 38 property." Section 48(a)(1)(A) provides, in relevant part, that the term "section 38 property" means tangible personal property "with respect to which depreciation * * * is allowable and having a useful life * * * of 3 years or more." Section 48(a)(1).[11]

Each of the items at issue clearly satisfies the threshold requirement that it be "tangible personal property."[12] In addition, we have already determined that the Code-a-phone, the air conditioner, and the lawn mower constitute "property used in the petitioner's trade or business" within the meaning of section 167(a)(1). Thus, whether petitioner qualifies for the investment tax credit in 1977 depends upon whether the useful life of these items is 3 years or more. Petitioner asserts that the useful life of the Code-a-phone, the lawn mower, and the air conditioner is each 7 years. This estimate is the same one used by him for depreciation purposes. Generally, in computing depreciation, the taxpayer must estimate the useful life of the asset and this estimation must be "reasonable." Section 1.167(a)-1(b), Income Tax Regs. Rev. Rul. 90, 1953-1 C.B. 43. Respondent has not placed petitioner's useful life estimate in issue and we find no reason to question or change it.

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[11] Although air conditioners are now excluded from the definition of "tangible personal property," there was no such exclusion in effect during the taxable year in question.

[12] Intangible personal property, such as a patent or a copyright, does not qualify for the investment tax credit. Sec. 1.48-1(f), Income Tax Regs.

Having determined that the Code-a-phone, the air conditioner, and the lawn mower all qualify as "section 38 property," we hold that petitioner qualifies for the investment tax credit with regard to these items. We note that no investment tax credit is allowable with respect to certain additional items claimed because petitioner presented no evidence in support of his claims. Rule 142(a).

III. Tax Return Preparation

An individual may deduct ordinary and necessary expenses incurred in connection with the determination, collection, or refund of any tax. Sec. 212(3).[13] The parties dispute the deductibility of certain amounts paid by petitioner to a certified public accountant in 1977 and 1978. Petitioner claims to have paid Grace Tanner, of Grace Tanner and Associates, amounts totaling $3,001 and $4,000 in 1977 and 1978, respectively, for tax related services. The parties now agree that $100 of the 1977 amount represents a fee paid to an attorney for nondeductible legal expenses associated with a real estate transaction. Petitioner contends, however, that the remaining amounts were for expenditures incurred solely in connection with the preparation of his 1977 and 1978 Federal income tax returns. The claimed deductions were disallowed because, as respondent urges, the checks submitted by petitioner to substantiate his expenditures do not provide any apportionment of the amounts properly attributable to section 212(3) expenses.

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[13] Sec. 212(3) provides that "[i]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year-- * * * (3) in connection with the determination, collection, or refund of any tax."

Petitioner has the burden of proving that he is entitled to a deduction under section 212(3). Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Although he was unable to recall specifically each of the payments in question, he provided credible testimony to the effect that Grace Tanner prepared his tax returns for the years in question and that the amounts at issue were paid to her for these tax services. His statements, however, were uncorroborated by the accountant who was not called by petitioner as a witness. We understand from petitioner's testimony that Grace Tanner was later sued by him for professional malpractice and that for this reason her testimony was not available in this case.

The only substantiation provided by petitioner consists of canceled checks which fail to provide us with an itemization or description of the specific services rendered by Grace Tanner. Petitioner's failure to provide such documentation makes it difficult for us to determine the portion of the accountant's fees allocable to tax advice and return preparation. Moreover, the amounts that petitioner alleges were expended for tax return preparation seem to us to be extraordinarily high. Based on petitioner's testimony, we are nevertheless convinced that a portion of the amounts in question consisted of amounts properly deductible pursuant to section 212(3). Bearing heavily against the petitioner, "whose inexactitude is of his own making," we find that 10 percent of the fees paid to Grace Tanner in 1977 and 1978 were for tax advice and, therefore, such amounts are deductible under section 212(3). Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930); Merians v. Commissioner, 60 T.C. 187 (1973).

IV. Addition to Tax under Section 6653(a)

In his notice of deficiency, respondent determined a section 6653(a) addition to tax. Section 6653(a) provides that if any portion of an underpayment is a result of negligence or intentional disregard of the rules and regulations, there will be added to the tax an amount equal to five percent of the underpayment.[14] A determination of negligence by respondent is presumptively correct and the petitioner has the burden of proving otherwise. Enoch v. Commissioner, 57 T.C. 781 (1972).

Petitioner testified that he employed a certified public accountant to prepare his 1978 Federal income tax return. He also testified that he relied exclusively on his accountant's tax counseling and advice. He argues that because of this reliance he should not be held subject to the section 6653(a) addition to tax. Petitioner testified that he was unsophisticated in tax matters and therefore had to completely rely on his accountant to advise him regarding the tax consequences of the transactions at issue. Although petitioner may have been well-intentioned, his duty to file accurate and timely income tax returns cannot be avoided solely by his misplaced reliance on his agent. Petitioner may, however, insulate himself from the negligence addition to tax if he can show that he provided his accountant with all the appropriate information to properly prepare his return. Pritchett v. Commissioner, 63 T.C. 149, 174 (1974); Pessin v. Commissioner, 59 T.C. 473 (1972); Enoch v. Commissioner, supra; Woodbury v. Commissioner, 49 T.C. 180

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[14] An "underpayment" is generally defined in the same manner as a deficiency (essentially the correct tax minus the reported tax) except that the amount reported on a late return does not reduce the amount of the underpayment. Sec. 6653(c)(1).

(1967).[15] This is especially true when income is understated because of expert advice as to includibility or deductibility.[16] The Supreme Court recently stated that:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. * * * [*United States v. Boyle*, 469 U.S. 241, 251 (1985). Citations omitted.]

In the instant case petitioner testified that he turned over to his accountant his receipts, documents, and whatever additional information that she requested. Accordingly, we conclude in these particular circumstances that the underpayment in 1978 was not due to petitioner's negligence or intentional disregard of the rules and regulations.

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[15] See also *Otis v. Commissioner*, 73 T.C. 671, 675 (1980), affd. in an unpublished opinion 665 F.2d 1053 (9th Cir. 1981); *Hill v. Commissioner*, 63 T.C. 225, 251 (1974); *Conlorez Corp. v. Commissioner*, 51 T.C. 467, 475 (1968); *Brockman Building Corp. Inc., v. Commissioner*, 21 T.C. 175 (1953), affd. 231 F.2d 145 (9th Cir. 1955); *Nelson v. Commissioner*, 19 T.C. 575, 581 (1952); *Horstmier v. Commissioner*, T.C. Memo. 1983-409, affd. without published opinion 776 F.2d 1052 (9th Cir. 1985); *O'Heron v. Commissioner*, T.C. Memo. 1981-648; *Singer v. Commissioner*, T.C. Memo. 1979-383.

[16] *Montpetit v. Commissioner*, T.C. Memo. 1982-715.

To reflect the concessions made by the parties and our conclusions with respect to the disputed issues,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-407

ORIGINAL

UNITED STATES TAX COURT

JAMES H. RUTTER and MARIE R. RUTTER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

J. H. RUTTER REX MANUFACTURING CO., INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 15061-81,
6343-82.

Filed August 28, 1986.

Edward B. Benjamin, Jr., and Robert W. Nuzum, for the petitioners.

Linda J. Bourquin, Linda K. West and H. Carl Zeswitz, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, Judge: Respondent determined deficiencies in petitioners' income and accumulated earnings taxes in the amounts[1] and for the years as follows:

Petitioner	Year	Deficiency in Income Tax	Accumulated Earnings Tax
James H. &	1977	$ 31,795	--
Marie R. Rutter	1978	11,694	--
	1979	31,660	--
J.H. Rutter Rex	1976	367,621	--
Manufacturing,	1977	199,800	$446,658
Co., Inc.	1978	199,800	598,077

The issues for decision are:

1. Whether a Form 872, which was executed by Eugene J. Rutter, the president of J.H. Rutter Rex Manufacturing Co. (Rutter Rex), on November 25, 1980, was a valid consent to extend the statute of limitations for Rutter Rex's taxable years 1976 and 1977 to December 31, 1981.

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[1] As a result of income tax adjustments made by respondent to the taxable income for the 1979 calendar year of J.H. Rutter Rex Manufacturing Co., which related to a disallowance of $365,500 of compensation paid to James and Eugene Rutter and of $137,975 for repair and maintenance expenses, a net operating loss carryback from the taxable year ending December 31, 1979 was not allowed as a carryback to the taxable year ending December 31, 1976, an investment tax credit carryback from the taxable year ending December 31, 1979 was not allowed as a carryback to the taxable year ending December 31, 1976, and a work incentive program (WIN) credit carryback from the taxable year ending December 31, 1979 was not allowed as a carryback to the taxable year ending December 31, 1976.

2. Whether the amounts paid by Rutter Rex to James H. Rutter and Eugene J. Rutter for taxable years 1976, 1977, 1978 and 1979 constitute reasonable compensation for services rendered within the meaning of section 162(a)(1)[2] and whether any part of such amounts paid to James H. Rutter during the years 1977, 1978 and 1979 constitute dividends which are not subject to the maximum tax on earned income.

3. Whether Rutter Rex was availed of so that its shareholders would avoid income tax by permitting earnings and profits to accumulate beyond the reasonable needs of the business in 1977 and 1978.

4. Whether Rutter Rex is entitled to deduct the $137,975 of repairs and maintenance expenses disallowed by respondent for the taxable year 1979.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

James H. Rutter and Marie R. Rutter, husband and wife, who resided in Covington, Louisiana at the time of the filing of the petition in this case, filed joint Federal income tax returns for the calendar years 1977, 1978 and 1979 with the Office of the Director, Internal Revenue

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Service Center, Austin, Texas. An amended return was also filed for calendar year 1979.

Rutter Rex is a Louisiana corporation with its principal place of business in New Orleans, Louisiana at the time of the filing of the petition in this case. Rutter Rex was incorporated on July 1, 1930 and is engaged in the clothing manufacturing business. James H. and Marie R. Rutter own 100 percent of the outstanding stock of Rutter Rex and have owned such stock since 1941. Of the 10,000 shares of stock of Rutter Rex outstanding, 9,990.8 were in the name of Mr. Rutter and the remaining 9.2 shares were in the name of Mrs. Rutter. Rutter Rex maintained its books and records and filed its Federal income tax returns on an accrual method of accounting and on a calendar year basis for the years in issue. Rutter Rex timely filed its Federal corporate income tax returns for the calendar years 1976, 1977, 1978 and 1979 with the Internal Revenue Service Center in Austin, Texas. Rutter Rex filed an amended return for taxable year 1979 and also timely filed corporate applications for tentative refund with respect to the 1979 taxable year.

From approximately 1942 through the years at issue, James H. Rutter (Mr. Rutter) has been the chairman of the board and chief executive officer of Rutter Rex and his son Eugene J. Rutter (Mr. Eugene Rutter) has been president and chief operations officer of Rutter Rex from 1960 through the years at issue.

From 1931 until 1980 dividends were paid to James and Marie Rutter as follows:

Year	Amount of Dividend
1966	$ 24,136
1967	4,850
1972	400,000

The board of directors of Rutter Rex determined whether Rutter Rex would pay a dividend. During the years in issue, Mr. Rutter, who was chairman of the board, had the final responsibility for all the major decisions and overall management of Rutter Rex, and Mr. Eugene Rutter, who was president of Rutter Rex, was responsible for the day to day operations of Rutter Rex. During the years in issue, Rutter Rex's board of directors consisted of Mr. Rutter and Mr. Eugene Rutter, Marie Rutter, Anna Mae Kenney and R.E. Vivien, Sr.

Consent to Extend Statute of Limitations

On December 28, 1979, Mr. Eugene Rutter, acting in his capacity as president of Rutter Rex, executed a Form 872, "Consent to Extend the Time of Assess Tax," extending the period for assessing the amount of any Federal income tax due from Rutter Rex for the period ending December 31, 1976 to any time on or before December 31, 1980.

On November 25, 1980, Mr. Eugene Rutter, acting in his capacity as president of Rutter Rex, signed another Form 872, "Consent to Extend the Time of Assess Tax," extending the periods for assessing the amount of any Federal income tax due from Rutter Rex for the periods ending December 31, 1976 and December 31, 1977 to any time on or before December 31, 1981. The consent was signed by Mr. Eugene Rutter in the presence of Jake Haney, controller for Rutter Rex, William Hogan, certified public accountant for Rutter Rex, Mr. Rutter, chairman of the board of Rutter Rex, and revenue agent McConnell who had presented the Form 872 to Mr. Eugene Rutter for signing. The signed Form 872 was date-stamped and received by respondent's audit division in New Orleans, Louisiana, on November 25, 1980, the same day it was signed by Mr. Eugene Rutter. It was also signed and dated on November 25, 1980, by Rene G. Daigre, the manager of the group of revenue agents to which Mr. McConnell was assigned in the New Orleans office of the Internal Revenue Service. Rutter Rex's appointed attorney-in-fact, Edward B. Benjamin, Jr., was not present when Mr. Eugene Rutter signed the Form 872. On October 15, 1980, Mr. Benjamin had sent a power of attorney, which appointed Mr. Benjamin as attorney-in-fact for Rutter Rex, to revenue agent McConnell. Mr. Benjamin had attended a meeting of representatives of Rutter Rex with Mr. McConnell on November 25, 1980, prior to the time when

Mr. Eugene Rutter signed the Form 872 and had stated that his clients would not execute the Form 872 at that time and that execution of the form would be discussed further at a December 3, 1980, meeting. Mr. Benjamin left the November 25, 1980, meeting prior to the time when Mr. Eugene Rutter signed the consent form. No written request for return of the consent was submitted by Mr. Rutter, Mr. Eugene Rutter, or Mr. Benjamin. Respondent issued a deficiency notice to Rutter Rex on December 17, 1981 for taxable years ending December 31, 1976, December 31, 1977, and December 31, 1978.

Reasonable Compensation

Rutter Rex manufactures work pants and work shirts, jeans, casual pants and casual shirts, and other clothing. The company works only from orders specifying the manufacture of specific items and has no retail distribution facilities.

Amounts designated as salaries and bonuses to Mr. Rutter and Mr. Eugene Rutter and deducted by Rutter Rex in the years 1976 through 1979 are as follows:

Year	James H. Rutter			Eugene J. Rutter		
	Salary	Bonus	Total	Salary	Bonus	Total
1976	$200,000	$225,000	$425,000	$125,000	$175,000	$300,000
1977	200,000	112,500 225,000	537,500	125,000	87,500 175,000	387,500
1978	200,000	337,500	537,500	125,000	262,500	387,500
1979	200,000	318,125	518,125	125,000	270,625	395,625

During the years in issue, Mr. Rutter determined his own and Mr. Eugene Rutter's salary and bonuses. During this time, the salaries and bonuses for all other management personnel of Rutter Rex were determined by Mr. Eugene Rutter but were subject to the approval of Mr. Rutter. Rutter Rex had officers and department heads for corporate functions including the following: John P. Douroux, Sr., vice president; John M. Drake, vice president; Anna Mae Kenney, secretary and assistant treasurer; and Frank A. Ulm, assistant secretary. Although both Messrs. Douroux and Drake had management responsibilities during the years in issue, all major corporate decisions were made by Mr. Rutter and Mr. Eugene Rutter, and neither Mr. Douroux nor Mr. Drake generated sales for Rutter Rex during those years. Rutter Rex's middle and lower level management personnel reported to Mr. Eugene Rutter and Mr. Eugene Rutter then reported to Mr. Rutter.

Mr. Douroux had the following responsibilities and duties: Confirming all details of the customer contracts; arranging the availability and pickup of piece goods and distributing the goods to plants for cutting; analyzing all incoming orders to determine marking by model, quantity and size of cuttings; making all cut sheets; controlling inventory and maintaining model stocks; distributing all finished goods to various warehouses and arranging for their transportation; completing the supervision of shipping departments for all the warehouses; contacting customers; making inquiries and following up with the customer; writing the customer weekly status reports; supervising all clerical personnel pertaining to the information necessary to complete the responsibilities mentioned above; and following through on all procedures instituted by Mr. Eugene Rutter.

Mr. Drake had the following duties and responsibilities: Overseeing and assisting in all phases of production and quality control in the manufacturing process of Rutter Rex; and preparing and attending to Government bidding and all problems relating to the completion of Government contracts.

Mrs. Kenney had the following duties and responsibilities: Maintaining the minute books; executing various legal documents such as leases; acting as the custodian of files required for Rutter Rex's legal suits; ascertaining interest rates for company investments; placing orders with banks for certificates of deposit or renewing maturing certificates; maintaining follow-up records on investments; signing checks for accounts payable, which includes verification of supports for payments and confirmation of payments; maintaining the report of cash receipts and bank acknowledgment of deposits; maintaining insurance records on executive and key personnel; performing all secretarial duties for Mr. Rutter; performing confidential secretarial duties for Mr. Eugene Rutter; and functioning as custodian of consumer contract files.

During the years in issue the compensation paid to the management staff of Rutter Rex was as follows:

Employee	Job Description	1976	1977	1978	1979
John Drake	Vice President - Production	$41,890	$58,655	$54,000	$66,600
John Douroux	Vice President - Planning	41,890	58,655	59,000	71,600
Anne Mae Kenney	Executive Secretary	32,290	43,915	46,200	55,280
Jake Haney	Controller	22,800	26,411	26,960	29,500
R.E. Vivien	Financial Administration	29,430	37,003	35,060	39,560
Nathan Shark	Engineer	24,230	30,132	29,200	32,480
Frank Miano	Plant Manager - Columbia, Miss.	30,810	40,265	37,600	45,160
Ernest Hingle	Plant Manager - Franklinton, LA	28,380	35,700	33,780	40,320
James Brousse	Plant Manager - New Orleans, LA	26,880	34,168	33,300	38,600
Kirk Drake	Asst. Plant Manager - New Orleans, LA	20,590	26,505	28,700	33,500
Ross Mule	Asst. Plant Manager - Franklinton, LA	21,090	25,755	28,200	33,500
Gene Simmons	Asst. Plant Manager - Columbia, Miss.	13,185	16,490	17,620	21,160
Jeff Easterling	Asst. Plant Manager - Columbia, Miss.	13,985	17,300	18,400	21,940
E.J. Rutter, II	Purchasing	10,183	18,810	23,050	31,160
J.H. Rutter, II	Local Sales	1,906	5,380	11,740	15,325
Lionel Casey	Payroll Administration	24,020	31,070	29,920	36,480
Paul Douroux	Asst. to President - Production	20,675	29,020	29,400	34,700
Ron Richardson	Warehouse Manager - Columbus, Ohio	15,810	21,600	23,000	27,800
Elmer Speer	Warehouse Manager - Columbia, Miss.	14,765	18,270	18,640	22,680
Robert Jacquet	Planning	19,165	23,980	23,800	29,600
Alan Assell	EDP Manager	15,625	20,574	20,760	24,800
Lee Connell	Local Sales	21,330	22,733	23,400	24,180
Don Lawrence	Asst. Plant Manager - Columbia, Miss.	12,435	15,700	3,750	—
Martin Mara	Marking Department	20,160	27,876	26,800	32,360

During the years in issue Rutter Rex paid annual hospitalization and life insurance premiums for its officers as follows:

Employee	1976 Hosp.	1976 Life	1977 Hosp.	1977 Life	1978 Hosp.	1978 Life	1979 Hosp.	1979 Life
J.H. Rutter	$194.64	$4,461	$283.80	$4,461	$189.12	$4,461	$288.12	$4,461
E.J. Rutter	194.64	1,724	283.80	1,728	189.12	1,728	288.12	1,728
A.M. Kenney	194.64	1,360	283.80	2,408	189.12	2,408	288.12	2,408
John Douroux	194.64	769	283.80	741	189.12	741	288.12	741
John Drake	194.64	557	283.80	485	189.12	677	288.12	741
Frank A. Ulm	194.64	52	283.80	56	189.12	56	288.12	56

During the years in issue Rutter Rex paid country club dues and purchased race track boxes for Mr. Rutter and Mr. Eugene Rutter as follows:

	JAMES H. RUTTER	EUGENE J. RUTTER
1976		
COUNTRY CLUB DUES	$1,082.60	$1,082.60
RACE TRACK BOXES	2,000.00	-0-
1977		
COUNTRY CLUB DUES	$1,769.60	$1,082.60
RACE TRACK BOXES	2,600.00	-0-
1978		
COUNTRY CLUB DUES	$1,125.00	$1,125.00
RACE TRACK BOXES	3,225.00	-0-
1979		
COUNTRY CLUB DUES	$ 762.00	$3,066.00
RACE TRACK BOXES	3,600.00	-0-

Mr. Rutter was born on March 30, 1904. On July 1, 1930, Mr. Rutter associated with two other individuals and formed Rutter Rex by acquiring a one-third stock interest in return for a $1,500 capital contribution. Although Mr. Rutter had the necessary manufacturing and accounting knowledge to start a clothing manufacturing business at that time, he did not have any sales experience or financial experience with respect to securing loans. By 1941, Mr. Rutter had bought out the other shareholders and he and Mrs. Rutter owned 100 percent of Rutter Rex. During World War II there was a scarcity of cloth and manpower but Rutter Rex was able to bid on and receive long-term Government contracts for military garments and was very successful during this time. During the war years, J.C. Penney (Penney's) contracted with Rutter Rex to manufacture clothing items requiring approximately 500,000 yards of cloth. In addition during the war years, Rutter Rex established a business arrangement with Montgomery Ward (Ward's) whereby Rutter Rex produced clothing items, stocked them in a field warehouse for Ward's and shipped them to Ward's upon request. During the war years, Rutter Rex also manufactured clothing items for Sears, Roebuck and Co. (Sears). Under the agreement with Sears, Mr. Rutter secured the piece goods and Rutter Rex manufactured the merchandise for Sears. Sears remained a major customer of Rutter Rex until Rutter Rex's 1954 labor strike.

Mr. Rutter's son, Mr. Eugene Rutter, who was born in 1928, began employment with Rutter Rex on a part-time basis in 1947. Mr. Eugene Rutter graduated from Tulane University with a degree in mechanical engineering in January 1950. Upon graduation he began working full-time at Rutter Rex. Mr. Eugene Rutter received extensive training in the clothing manufacturing business with Rutter Rex and has performed most jobs, including all sewing operations required on shirts, pants and jeans, during his years at Rutter Rex. He started as a bundle-boy, which involved moving bundles for the sewing machine operators. He was also an assistant truck driver, was employed in the marketing department, pattern-making department, shipping department, and pattern-grading department.

In 1953, Rutter Rex opened a pants manufacturing plant in Franklinton, Louisiana, which is about 65 miles north of New Orleans. When a certain quality level was achieved, the Franklinton plant began manufacturing pants for Penney's. The Franklinton plant was the first plant in the United States to manufacture permanent press work pants for Penney's. Mr. Eugene Rutter was responsible for running the Franklinton plant and his schedule dictated that he live in Franklinton during the work week for 7 months.

In 1954, the Amalgamated Clothing Workers of America Union (ACWA) organized a labor strike at Rutter Rex's New Orleans plant. The union members organizing the strike locked out Rutter Rex's employees who wanted to work in the plant. The 1954 strike lasted approximately 1 year and resulted in a substantial interruption of production and the loss of several of Rutter Rex's long-time customers, including Sears and Ward's. The strike disrupted the business that Rutter Rex received from the United States Armed Forces. Due to the inability of Mr. Rutter and the union and Government officials to reach an agreement, the Government canceled its military contracts with Rutter Rex.

In 1954, Rutter Rex completed an addition to one of the buildings at its New Orleans plant. In 1955, Rutter Rex opened a shirt and pants manufacturing plant in Columbia, Mississippi. Mr. Eugene Rutter was primarily responsible, with the help and agreement of Mr. Rutter, for all phases of the establishment of Rutter Rex's Columbia manufacturing plant. In 1957, Rutter Rex established a Fresno, California warehouse to service the Penney's contract. In 1959, Rutter Rex established a Columbus, Ohio warehouse to service Penney's.

During the years 1976 through 1979, Mr. Rutter and Mr. Eugene Rutter had final responsiblity for all aspects of Rutter Rex's business, including financing, sales, production, purchasing, quality control, trucking, transportation, warehousing, customer service, cost control, material usage and supervision. During those years, Mr. Rutter made final decisions with respect to all aspects of Rutter Rex's business. During the years in issue, Mr. Rutter was in Rutter Rex's office on a regular basis and when he was not in the office, he was either at one of the factories, traveling to call on customers, or at his home located approximately midway between Rutter Rex's factories and its main office in New Orleans. Mr. Rutter would usually arrive at Rutter Rex's office between 7:30 a.m. and 8:00 a.m. and the amount of time he would stay in the office depended on what had to be done on that day. He would often drive to the factories when he left the office to verify that everything was running as planned. Sometimes he would leave his home in Covington and drive directly to the factories without going to the office.

During the years in issue, Mr. Eugene Rutter and Mr. Rutter traveled on company business to call on Rutter Rex's customers who were located primarily in New York City and San Francisco. During this time, Rutter Rex did not spend any money on advertising except for placing its name on its company trucks. During the years in issue, Rutter Rex did not employ a sales force to call on customers and generate sales because Mr. Rutter decided that he should control the sales activities of Rutter Rex.

During the years in issue, Mr. Rutter and Mr. Eugene Rutter were responsible for all decisions relating to the modernization of the business, including establishing new plants and warehouse facilities, instituting quality inventory and cost controls, introducing new concepts relating to productivity and employee morale, introducing the use of computers in the marking department and determining and submitting bids for Government contracts. Mr. Rutter and Mr. Eugene Rutter were also responsible for material usage and control, including the purchasing of cloth inspection machines, supervising and training personnel on material usage and establishing quality control programs pertaining to piece goods, trimmings, inventory and completed garments.

In his notice of deficiency issued to Rutter Rex, respondent disallowed a portion of the deductions claimed for compensation to Mr. Rutter and Mr. Eugene Rutter with the following explanation:

> The deductions for compensation paid your officers during the taxable years ended December 31, 1976, December 31, 1977 and December 31, 1978 must be reduced $326,250.00, $416,250.00 and $416,250.00 respectively. This is the amount which exceeds a reasonable allowance for salaries or other compensation for personal services rendered within the meaning of section 162 of the Internal Revenue Code. The following tabulation shows the amounts claimed, allowed, and disallowed as compensation.

1976

	CLAIMED	ALLOWED	DISALLOWED
J.H. Rutter	$425,000.00	$233,750.00	$191,250.00
E.J. Rutter, Sr.	300,000.00	165,000.00	135,000.00
TOTAL			$326,250.00

1977

	CLAIMED	ALLOWED	DISALLOWED
J.H. Rutter	$537,500.00	$295,625.00	$241,875.00
E.J. Rutter, Sr.	387,500.00	213,125.00	174,375.00
TOTAL			$416,250.00

1978

	CLAIMED	ALLOWED	DISALLOWED
J.H. Rutter	$537,500.00	$295,625.00	$241,875.00
E.J. Rutter, Sr.	387,500.00	213,125.00	174,375.00
TOTAL			$416,250,00

In his notice of deficiency issued to James H. and Marie R. Rutter, respondent determined that of the salary and bonuses Mr. Rutter received for the taxable years ending December 31, 1977, December 31, 1978 and December 31, 1979 in the amounts of $537,500, $425,000 and $537,500, respectively, Mr. Rutter received dividends from Rutter Rex in the respective amounts of $241,875, $128,875 and $226,625 and therefore to this extent the amounts he received from Rutter Rex were not limited by the maximum tax on earned income.

Accumulated Earnings and Profits

During the years 1977 and 1978, Rutter Rex accounted for its inventories on a LIFO (last in first out) basis for purposes of its Federal corporate tax returns and it accounted for its inventories on a LIFO basis for purposes of its financial statement prepared by its accounting firm.[3]

The records of Rutter Rex are adequate for most months to convert its inventories to a FIFO (first in first out) basis. The inventory values of Rutter Rex on a FIFO basis at the end of the months of 1977 and 1978 are as follows:

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[3] The parties agree that Rutter Rex's LIFO inventory should be converted to FIFO inventory for purposes of calculating the inventory cycle because the FIFO method of inventory valuation, which values inventories on the assumption that the goods first acquired and placed into inventory are the goods which are first used in the manufacturing process and taken out of inventory, provides a truer and more accurate inventory valuation for purposes of determining corporate liquidity than LIFO valuation.

J.H. RUTTER REX MFG. CO., INC.
INVENTORY PRICED AT FIFO

	1977	1978
January	N/A	$3,943,013
February	N/A	3,661,896
March	3,907,633	3,620,968
April	3,940,954	4,383,658
May	4,074,267	4,675,521
June	4,136,175	3,991,027
July	3,980,486	4,337,656
August	4,156,819	4,505,495
September	3,862,379	4,409,815
October	4,050,421	4,110,729
November	4,044,222	3,859,300
December	5,254,884	4,412,191

The accounts receivable of Rutter Rex at the end of each month in 1977 and 1978 are as follows:

J.H. RUTTER REX MFG. CO., INC.
ACCOUNTS RECEIVABLE

	1977	1978
January	$2,974,847	$1,594,017
February	2,393,797	2,370,426
March	2,606,024	1,861,487
April	2,135,932	1,834,831
May	1,738,937	1,607,875
June	2,174,390	2,201,797
July	1,732,649	1,326,469
August	1,848,366	1,808,583
September	2,111,687	2,443,410
October	1,959,784	2,599,842
November	1,651,707	2,399,636
December	184,449	1,327,532

The accounts payable of Rutter Rex at the end of each month in 1977 and 1978 are as follows:

J.H. RUTTER REX MFG. CO., INC.
ACCOUNTS PAYABLE

	1977	1978
January	$ 513,432	$ 634,592
February	368,989	443,468
March	762,027	581,568
April	920,847	972,943
May	819,583	815,616
June	716,655	730,129
July	862,436	494,995
August	917,315	559,354
September	930,445	790,252
October	1,013,322	786,430
November	449,076	507,890
December	664,825	738,019

The balances of cash and cash equivalents of Rutter Rex for each month of 1977 and 1978 are as follows:

	1977	1978
January	$2,072,579	$4,120,114
February	3,606,930	3,642,767
March	3,349,492	3,642,767
April	3,451,129	4,821,105
May	3,959,449	4,483,830
June	3,956,496	4,236,329
July	4,540,592	4,741,587
August	4,372,416	4,498,629
September	4,747,711	4,525,704
October	5,653,629	5,021,738
November	4,379,021	5,683,954
December	4,540,589	5,067,762

Rutter Rex's net liquid assets, which are current assets minus current liabilities with inventories valued on the FIFO basis, were $7,329,170 and $8,151,306 as of December 31, 1977 and December 31, 1978, respectively. These figures include estimated Federal and Louisiana State income tax associated with the inventory adjustment from LIFO to FIFO at a total of 50.25 percent.[4] The accumulated earnings and profits with inventories stated on the FIFO basis as of December 31, 1976, were $6,500,068, and as of December 31, 1977, were $7,419,183.

Rutter Rex's business is dependent on changes in styles and fads and it requires adapting its manufacturing facilities to satisfy the needs of its customers. Penney's was one of Rutter Rex's largest customers during the years in issue and required that Rutter Rex purchase the materials used to manufacture the clothing items at its own cost and hold the finished goods in inventory at its expense until shipment was requested. During his childhood Mr. Rutter was taught not to borrow money and in later years followed this philosophy and only borrowed money from banks as a last resort. Rutter Rex did not have any bank loans outstanding on December 31, 1971 through December 31, 1981, and its last outstanding borrowings were $250,000 on December 31, 1964 and $200,000 on December 31, 1970.

Rutter Rex received discounts for the prompt payment of purchase invoices during the years 1976 through 1979 and these purchase discounts were reflected on Rutter Rex's financial statements. Rutter Rex's financial statements for the years ending December 31, 1976, December 31, 1977, December 31, 1978 and December 31, 1979 reflected that Rutter Rex received cash discounts for prompt payment of invoices in the amounts of $101,315, $117,988, $114,352, and $167,008, respectively.

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[4] Respondent has conceded on brief that estimated tax at 50.25 percent should be applied in order to account for Louisiana State tax at 2.25 percent.

During the years 1976 through 1978, the New Orleans plant manufactured pants and shirts for the Government under contracts. Rutter Rex was required to convert its Columbia shirt plant from the manufacturing of Levi's shirts to Government shirts in 1977 and from the manufacturing of Government shirts to Penney's shirts in 1978. It closed its Columbia jeans plant for 8 months during 1977 and for 6 months during 1978. Various training and retraining costs were associated with these changes. Retraining costs were for retraining an operator already employed by Rutter Rex who was switched to manufacturing a different product, and training costs were for training an operator who had not been employed previously by Rutter Rex. Each clothing item manufactured by Rutter Rex during the years 1976 through 1979 was made by a number of different employees who were responsible for various operations. One person did not make an entire garment. During 1977 and 1978, Rutter Rex maintained a blanket combined insurance coverage against property damage and business interruptions as well as "fire, sprinkler, leakage, tornado, explosion, smoke damage, use and occupancy" for all locations in the total amount of $19,186,000 for each year.

With the exception of the allowance for doubtful accounts and the depreciation items, no reserves for any contingencies, business interruptions, or potential liabilities are set forth on Rutter Rex's balance sheets for 1977 or 1978.

Rutter Rex's contracts with Penney's and Ward's during 1977 and 1978 had the "terms/trade discount" of "net 30 days." In one contract with Penney's, Rutter Rex was instructed to use piece goods from J.P. Stevens on the terms "net 60 days." In other contracts with Penney's, Rutter Rex was instructed to use piece goods from Klopman Mills and the terms of these purchases were not stated in the contracts.

Rutter Rex's sales to Penney's accounted for approximately 45 percent of total sales in 1977 and 50 percent of its total sales in 1978. During the years 1976 through 1979 Penney's provided Rutter Rex with a contract for the manufacture of a particular type of clothing.

Officials of Penney's informed Mr. Rutter and Mr. Eugene Rutter during the years here in issue that they had decided to have Penney's get out of the work clothing business and that Rutter Rex could expect a diminishing volume of business from Penney's. The following chart shows the dozens produced by Rutter Rex for Penney's from 1971 through 1984:

Year	Dozens Produced
1971	188,343
1972	278,537
1973	313,710
1974	239,705
1975	158,154
1976	142,924
1977	184,800
1978	171,658
1979	181,891
1980	115,116
1981	65,535
1982	88,031
1983	73,916
1984	63,350

The United States Government was also a major customer of Rutter Rex during the years 1977 and 1978. The minutes of the board of directors of Rutter Rex dated December 29, 1978 and December 20, 1979 refer to a the potential loss by Rutter Rex of its Government contract business. Rutter Rex's sales to the United States Government accounted for approximately 41.2 percent of total sales in 1977 and 35 percent of total sales in 1978, but less than 1 percent of total sales in 1979. Rutter Rex has been involved in numerous National Labor Relations Board cases and in several lawsuits involving regulations pertaining to Government contracts, but no labor problems occurred in 1977 or 1978. The only strike experienced by Rutter Rex was in 1954, and most of its National Labor Relations Board cases had their origin in this strike. Most of the cases involving Government contracts related to limitations on bids for certain work to small businesses with under 500 employees.

In his notice of deficiency issued to Rutter Rex, respondent determined that the company was subject to the accumulated earnings and profits tax provided for in sections 531 and 532 for taxable years ending December 31, 1977 and December 31, 1978 with the following explanation:

> It has been determined that your organization was formed or availed of so your shareholders would avoid income tax by permitting earnings and profits to accumulate instead of being divided or distributed during the taxable year ended December 31, 1977 and December 31, 1978. * * *

Repairs and Maintenance Expenses

On its 1979 Federal income tax return, Rutter Rex claimed a deduction for repairs in the amount of $29,167. In addition, included in Rutter Rex's calculation of cost of goods sold was the amount of $227,189 for maintenance and repair expenses. These expenditures were made by Rutter Rex in connection with its New Orleans and Franklinton plants. Rutter Rex added a lunch area, restrooms, a loading and unloading ramp to these plants and did some interior painting and refurbishment of them. Some of the changes were made to enable Rutter Rex to make panatela jeans for Levi. Petitioner began work on additions and improvements in early January 1979. Respondent determined that only $118,381 of these expenses claimed as a deduction for repairs and maintenance as a part of cost of goods sold were currently deductible in 1979 and disallowed $137,975 of these claimed deductions for repairs and maintenance with the explanation that the--

> additions/improvements to both plants were under proposal in late November 1978. The work was actually started in early 1979. The taxpayer is entitled to capitalized [sic] the expenses incurred under code section 167.

OPINION

Consent to Extend Statute of Limitations

Section 6501(a) provides, as a general rule, that--

> the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) * * * and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

The relevant exception to the 3-year rule in section 6501(a) is embodied in section 6501(c)(4) which provides:

> (c) Exceptions.--
>
> * * *
>
> (4) Extension by agreement.--Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, * * * both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

See also section 301.6501(c)-1(d), Proced. & Admin. Regs.

The period of limitations applicable to the years 1976 and 1977 under section 6501(a) expired on March 16, 1980 and March 15, 1981, respectively.

When a taxpayer shows that assessment of a tax is barred by the general statute of limitations, respondent bears the burden of introducing into evidence consents, valid on their face, that extend the period of limitations for assessment up to the date of mailing of the notice of deficiency. Robinson v. Commissioner, 57 T.C. 735, 737 (1972); Concrete Engineering Co. v. Commissioner, 19 B.T.A. 212 (1930), affd. 58 F.2d 566, 568 (8th Cir. 1932).[5]

After respondent introduces consents which are valid on their face, and a taxpayer asserts that any consent is ineffective, the taxpayer bears the burden of proving the invalidity of such consent. Crown Willamette Paper Co. v. McLaughlin, 81 F.2d 365, 367 (9th Cir. 1936); Concrete Engineering Co. v. Commissioner, supra.[6]

Petitioner contends that the Form 872, signed by Mr. Eugene Rutter on November 25, 1980, was ineffective to prevent the period of limitations for assessment of the deficiencies for calendar years 1976 and 1977 from expiring prior to the issuance of the statutory notice of deficiency. Petitioner contends that although the Form 872 was signed by the company's president, Mr. Eugene Rutter, it was not dated by him but was dated by an employee of respondent. Petitioner contends that when an employee dated the Form 872, it was unilaterally altered by respondent's employees.[7]

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[5] See also Lefebvre v. Commissioner, T.C. Memo. 1984-202.

[6] See also Rault v. Commissioner, T.C. Memo. 1982-283.

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[7] Petitioner relies heavily on Mantzel v. Commissioner, T.C. Memo. 1981-169, to support his position that Mr. Eugene Rutter's failure to date the Form 872 renders it ineffective to extend the statute of limitations for Rutter Rex's 1976 and 1977 taxable years. In Mantzel, the taxpayers were mailed a Form 872 to be executed and returned. They signed the Form 872 but failed to date the form. The taxpayers did not remember when they signed the form or when they returned the form to respondent. If the normal procedures in respondent's office had been followed, the Form 872 would have been received by a clerk, stamped with the date of receipt, examined by a revenue agent to verify its timely receipt and signed and dated by respondent's returns program manager. In addition, if such form had not been received at least 15 days prior to the running of the period of limitations, a notice of deficiency would have been prepared. This notice would have been destroyed if the Form 872 had later been received within the period of limitations but would have been mailed to the taxpayers on the last day of the period if the Form 872 had not been received in time. In Mantzel the Form 872 was not stamped with a date when it was received by respondent from the taxpayers. At some time, the form was signed by the returns program manager but he also failed to date the form. This Court concluded that respondent failed to carry his burden of proving that the consent was executed prior to the running of the statute of limitations because it could not be determined from the record when the Form 872 was in fact executed on behalf of respondent and it was possible that the form was not returned by the taxpayers until after or shortly before the expiration of the period of limitations and that respondent simply neglected to prepare a notice of deficiency. It was
(footnote continued)

Petitioner relies on Cary v. Commissioner, 48 T.C. 754 (1967), to support his position that respondent's unilateral alteration of the consent form by dating it without Rutter Rex's consent operated to invalidate the Form 872 previously signed by Mr. Eugene Rutter. In Cary, we held that a Form 872 signed by the taxpayer but later altered by an employee of respondent before the consent was accepted was invalid. An employee of respondent gave the taxpayer a Form 872 to sign with an error in the taxable year for which the extension was sought. Nevertheless, the taxpayer signed the consent and submitted it to respondent with the wrong year. At that time an employee of respondent corrected the taxable year without any consultation with the taxpayer or his representative. Respondent merely sent a copy of the altered document to the taxpayer's representative. At the time the respondent made the correction, there remained at least 15 days to obtain a proper Form 872. We concluded that the altered

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(footnote continued from previous page) also possible that the Form 872 was received by respondent in time, that it was subsequently put aside or misplaced, and that it was given to an employee for signing only after the period of limitations had expired. We concluded that respondent's failure to handle the case in accordance with normal procedures made it impossible for us to infer from respondent's failure to prepare a timely notice of deficiency that the Form 872 was received and executed in due course.

Form 872 did not constitute a valid consent in writing by both parties as required in section 6501(c)(4).

Petitioner argues that Mr. Eugene Rutter did not date the Form 872 when he signed it because he thought it would be ineffective without the date. Petitioner argues that the "11/25/80" date contained on the Form 872, following Mr. Eugene Rutter's name, was not in Mr. Eugene Rutter's handwriting but was written by a left-handed person. Petitioner points out that revenue agent McConnell was left-handed. Therefore petitioner concludes that revenue agent McConnell dated the Form 872 before he turned it in to his supervisor for his signature. Petitioner argues that Mr. Eugene Rutter did not date the Form 872 because he accepted Mr. McConnell's assurances that he would hold the Form 872 and not release it to his supervisor until after a meeting scheduled for December 3, 1980, had occurred. Petitioner also argues that the Form 872 was null and void because it was obtained under duress and fraud due to the actions of revenue agent McConnell.[8]

Respondent contends that the statute of limitations for the years 1976 and 1977 had not run at the time the statutory notice of deficiency was issued to Rutter Rex on December 17, 1981 due to the existence of a properly executed consent extending the period of limitations to December 31, 1981, pursuant to section 6501(c)(4). Respondent argues that petitioner has not satisfied its burden of proving fraud or duress by respondent's agents in obtaining the consent form.

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[8] Petitioner cites Robertson v. Commissioner, T.C. Memo. 1973-205, to support his position that revenue agent McConnell's actions constitute duress and result in the nullity and invalidity of the Form 872. That case has no factual similarity to the present case. See Jarvis v. Commissioner, T.C. Memo. 1980-381, in which the Robertson case is distinguished.

In our view, petitioner has not satisfied its burden of proving that the signed consent was invalid. The instant case is distinguishable from Cary v. Commissioner, supra, as previously discussed and from the other cases relied on by petitioner. Here, there was an agreement between the parties to extend the statute for the years 1976 and 1977. The Court's holding in the Cary case was based on the absence of an agreement between the parties as to the taxable year for which the extension was sought.

In the instant case, the record is absolutely clear that Mr. Eugene Rutter signed the consent form on November 25, 1980. The record is not clear as to who wrote the date after Mr. Eugene Rutter's signature. However, since the record is clear as to the date the Form 872 was signed by Mr. Eugene Rutter, the date it was received by the Internal

Revenue Service and the date it was signed on behalf of respondent, we do not consider it to be material who placed the "11/25/80" on the form following Mr. Eugene Rutter's signature. It is clear to us from the record that Mr. Eugene Rutter understood the effect of his action in signing the Form 872, and signed it of his own free will on November 25, 1980.

Petitioner has also failed to establish that the Form 872 was obtained under duress and fraud. We defined duress in Diescher v. Commissioner, 18 B.T.A. 353, 358 (1929), as follows:

> In modern jurisprudence the definition of duress has been enlarged much beyond the narrow limits recognized in the common law. It is now well settled that if an act of one party deprives another of his freedom of will to do or not to do a specific act the party so coerced becomes subject to the will of the other, there is duress, and in such a situation no act of the coerced person is voluntary and contracts made in such circumstances are void because there has been no voluntary meeting of the minds of the parties thereto. * * *

In Diescher, the revenue agent threatened to impose the fraud addition against the taxpayer unless the taxpayer executed the waiver (consent) extending the period of limitations. We held that the taxpayer, when he signed the waiver under such circumstances, was not acting with a free will but was coerced by the will of respondent.[9]

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[9] In Robertson v. Commissioner, T.C. Memo. 1973-205, a consent was executed by the taxpayer under duress where the revenue agent offered the taxpayer a choice between signing (footnote continued)

Petitioner argues that revenue agent McConnell intentionally waited until Rutter Rex's appointed attorney, Mr. Benjamin, left the room before coercing Mr. Eugene Rutter to sign the Form 872. Petitioner argues that Mr. McConnell's actions violate the provisions of section 2 of Pub. L. 89-332, which were codified at 5 U.S.C. sec. 500(f) (1982), and provide as follows:

> When a participant [taxpayer] in a matter before an agency [Internal Revenue Service] is represented by an individual qualified under subsection (b) or (c) of this section, a notice or other written communication required or permitted to be given the participant in the matter shall be given to the representative in addition to any other service specifically required by statute. * * *

This issue was resolved in Neuhoff v. Commissioner, 75 T.C. 36, 42-43 (1980), affd. per curiam 669 F.2d 291 (5th Cir. 1982), wherein we stated as follows:

> The provisions of 5 U.S.C. sec. 500 et seq., were enacted to enable, as far as possible, persons to be represented by any attorney in good standing in matters before Federal agencies and to require the agencies to deal with a representative qualified in the manner provided by Congress. H. Rept. 1141, 89th Cong., 1st Sess. (1965), U.S. Code Cong. & Adm. News 4170 (1965). See Houghton v. Commissioner, 48 T.C. 656, 664 (1967); Alfieri v. Commissioner, 60 T.C. 296, 299 (1973), affd. without opinion 487 F.2d 1393 (2d Cir. 1973). While respondent failed to comply with 5 U.S.C. sec. 500(f) by not notifying petitioner's legal representative with respect to the consent, we find such failure to be harmless under the facts of this case. * * *
>
> Moreover, 5 U.S.C. sec. 500(f) does not modify the Internal Revenue Code provisions specifying the manner in which the period of limitations may be extended. Alfieri v. Commissioner, supra.

(footnote continued from previous page)
the consent or subjecting his property to seizure.

In our view revenue agent McConnell's conduct in obtaining the consent does not constitute harassment, coercion or duress. Revenue agent McConnell was under no obligation to request an extension of the statute of limitations only from Mr. Benjamin. In addition, revenue agent McConnell was not obligated to stop Mr. Benjamin from leaving the room before the Form 872 was signed by Mr. Eugene Rutter. Despite the existence of the power of attorney in Mr. Benjamin, Mr. Eugene Rutter was the president of Rutter Rex and was totally aware of the effect of signing the Form 872. He was a sophisticated businessman accustomed to signing legal documents. He possessed the authority to sign the Form 872 on behalf of the corporate petitioner. See Narragansett Wire Co. v. Commissioner, 491 F.2d 371, 373 (1st Cir. 1974), affg. a Memorandum Opinion of this Court. The fact that Rutter Rex also gave its attorney the power to sign on its behalf does not invalidate an otherwise valid consent signed by Mr. Eugene Rutter with full knowledge of its legal consequences. Neuhoff v. Commissioner, 75 T.C. at 42.

Mr. Benjamin was notified several times of respondent's efforts to obtain a signed consent and he advised his clients not to sign it at the November 25, 1980, meeting. When Mr. Eugene Rutter signed the Form 872 after Mr. Benjamin left, he obviously chose not to follow his attorney's advice. He cannot successfully now claim he did not intend it to be enforceable. This was not Mr. Eugene Rutter's first experience with a Form 872 and its legal consequences. He had signed one approximately one year earlier on December 28, 1979, and understood its legal effect.[10] Mr. Eugene Rutter was not alone or unadvised when he signed the Form 872 in issue. He signed it in the presence of his father, Mr. Rutter, who was the company's chairman of the board, the company's C.P.A., Mr. Hogan, with whom he conferred before he signed it, and Mr. Haney, who was the controller of Rutter Rex. At trial, Mr. Eugene

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[10] At the trial, Mr. Eugene Rutter testified that he signed the Form 872 only after revenue agent McConnell told him he would not turn the form over to his superior for signing until after the December 3, 1980, meeting he was to have with representatives of Rutter Rex. Later, when Mr. Eugene Rutter produced the notes he had written shortly after signing the Form 872, these notes showed that Mr. Eugene Rutter did know that revenue agent McConnell intended to take the Form 872 that day to be signed by his superior. Specifically, the notes stated: "He [revenue agent McConnell] took the papers, put them in his brief case saying he was going right down to the office with them for his superiors to sign." There is nothing in the notes to indicate that Mr. Eugene Rutter was surprised by revenue agent McConnell's statement or asked for the return of the Form 872. We conclude from the evidence as a whole that revenue agent McConnell did not tell Mr. Eugene Rutter that he would not turn over the signed Form 872 to his superiors for signing until after the December 3, 1980, meeting.

We further conclude that Mr. Eugene Rutter and the other representatives of Rutter Rex who were present when Mr. Eugene Rutter signed the Form 872 knew that revenue agent McConnell intended to have the Form 872 promptly signed on behalf of respondent and also knew the legal significance of Mr. Eugene Rutter's signing the Form 872 and giving it to revenue agent McConnell.

Rutter explained that he signed the Form 872 only to show that Rutter Rex "intended to play fairly."

Petitioner contends respondent's act of dispatching revenue agent McConnell to reaudit taxable years 1976 through 1978 after a prior agent had proposed deficiencies for those years in the total amount of $26,915 which petitioner had paid on or about February 12, 1980, was harassment. The record shows that Mr. McConnell was sent to continue the examination which had been started by another agent who had left the Service. The other agent had turned in the case as an agreed case, but his report was not accepted. There was no harassment of representatives of Rutter Rex by respondent's continuing an examination of the tax liability of a company after an agent had submitted an agreed report which was not approved and accepted by his superiors.

Petitioner has presented no evidence of unlawful threats or coercion upon Mr. Eugene Rutter when he signed the Form 872. We hold that the consent extending the statute of limitations signed by Mr. Eugene Rutter was valid and that assessment of deficiencies for the years 1976 and 1977 were not barred by the statute of limitations when the deficiency notice was issued.

Reasonable Compensation

Section 162(a) provides in pertinent part:

> (a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

Whether compensation is reasonable is a question to be resolved on the basis of an examination of all the facts and circumstances of this case. Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1155 (1980), and cases cited therein. Respondent's determination is presumptively correct and petitioner has the burden of proving to the contrary. Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner, 61 T.C. 564 (1974), affd. 528 F.2d 176 (10th Cir. 1975). In the Pepsi-Cola Bottling Co. case, we quoted some of the factors relevant in determining reasonableness of compensation listed in Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949), reversing a Memorandum Opinion of this Court, to be--

> the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years. * * *

Where officers-shareholders, who are in control of the corporation, set their own compensation, careful scrutiny is required to determine whether the purported compensation may be a disguised dividend. Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 152 (8th Cir. 1974), affg. a Memorandum Opinion of this Court, cert. denied 420 U.S. 908 (1975); Home Interiors & Gifts, Inc. v. Commissioner, supra at 1156. Section 1.162-7(b)(1), Income Tax Regs., provides:

> (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. * * *

Respondent contends that there was no arms-length, freely bargained agreements between Rutter Rex and Mr. Rutter and Mr. Eugene Rutter. Respondent notes that the profits of a corporation should be distributed to the shareholders as dividends rather than being paid out as excessive compensation. Respondent argues further that the high salaries paid to the Rutters were merely a method of draining off corporate profits at a tax advantage.

Respondent states that the record does not reflect the number of hours Mr. Rutter devoted to Rutter Rex during the years in issue and emphasizes that the amount of time a corporate officer devotes to the job is a factor in determining reasonable compensation. In addition, respondent contends that there is no evidence that Mr. Rutter's and Mr. Eugene Rutter's salary increases were supported by concomitant increases in the nature, scope or extent of their work efforts for Rutter Rex. Respondent points to an absence of both major diversification of products or the addition of physical plants during the years in issue. Respondent contends that the growth Rutter Rex experienced in the 1950's and 1960's was common in the industry rather than necessarily attributable to the efforts of the Rutters.

To support his conclusion that the salaries in issue were excessively high, respondent points out that for the years 1976, 1977 and 1978, the combined compensation of Mr. Rutter and Mr. Eugene Rutter averaged 39.8 percent of net corporate income, more than twice the average of comparable companies.

Respondent also argues that the dividend history of Rutter Rex supports his position. From 1931 through 1980, Rutter Rex only declared dividends in 1966, 1967 and 1972.

Respondent contends that a comparison of the compensation of Mr. Rutter and Mr. Eugene Rutter with that of the top five non-family member employees of Rutter Rex is indicative that the Rutters' compensation was excessive. Mr. Rutter received 1.9 to 2.4 times the aggregate compensation of these five employees and Mr. Eugene Rutter received 1.4 to 1.7 times the aggregate compensation of these five employees.Respondent concludes that the salaries of non-family members are disproportionate when compared to the compensation paid to Mr. Rutter and Mr. Eugene Rutter.

At trial, both parties presented expert testimony regarding reasonable compensation to the Rutters. Respondent presented the reports of two experts who gave opinions as to the maximum compensation for positions comparable to those held by Mr. Rutter and Mr. Eugene Rutter.

Ernest Gruenfeld, an employee of the valuation analysis section of the Internal Revenue Service, has experience in the compensation area. He concluded that the compensation paid to Mr. Rutter and Mr. Eugene Rutter was unreasonable and excessive.

Mr. Gruenfeld based his opinion primarily on a comparison of the amounts paid to the Rutters with the amounts paid by the following companies to their top executives:

	Millions in Sales in 1976	1976	1977	1978	1979
1. Bayly:					
Top		$106,167	$126,844	$136,679	$193,615
Second	$81,000,000	99,266	109,138	130,238	159,906
2. Hampton:					
Top		176,046	186,746	249,362	310,033
Second	69,000,000	117,238	133,288	170,282	225,065
3. Harwood:					
Top		110,000	131,125	146,462	126,073
Second	57,000,000	108,435	110,000	110,000	110,000
4. Miller Bros.:					
Top		142,170	87,537	94,367	95,917
Second	28,000,000	116,418	66,997	72,358	73,683
5. Noel:					
Top		88,442	142,312	156,243	163,445
Second	24,000,000	59,442	91,349	91,867	105,138
6. Stanwood:					
Top		100,200	118,200	148,400	217,200
Second	77,000,000	106,040	96,900	117,200	101,500
7. Winter, Jack					
Top		235,128	263,077	260,000	200,000
Second	75,000,000	105,160	116,314	115,000	90,000

According to Mr. Gruenfeld, reasonable compensation for the Rutters should be the following amounts:

	James H. Rutter	Eugene J. Rutter
1976	$125,000	$ 95,000
1977	130,000	90,000
1978	175,000	120,000
1979	150,000	100,000

As petitioner points out, there are differences in the business of Rutter Rex and the comparative companies Mr.

Gruenfeld listed. We agree and therefore do not accept the amount determined by Mr. Gruenfeld. However, we do consider the amounts paid by publicly held companies in the garment manufacturing business to have relevance in the overall determination of a reasonable salary for each of the Rutters.

E. James Brennan III, who is president of Brennan, Thomsen Associates, Inc., a corporation of personnel and pay practice consultants, also testified on behalf of respondent. Mr. Brennan investigated and analyzed the competitive executive pay practices for the apparel industry from 1976 through 1979. Mr. Brennan made the following analysis:

HIGHEST TOTAL PAY AMOUNTS

		CHAIRMAN		PRESIDENT	
Year	Sales	Competitive Average	Maximum Reasonable	Competitive Average	Maximum Reasonable
1976	$21,600,000	$ 96,200	$107,700	$68,500	$ 85,000
1977	25,000,000	101,300	117,300	77,800	111,000
1978	24,400,000	99,700	145,400	74,600	119,700
1979	21,900,000	108,400	172,000	79,700	159,500

Mr. Brennan's conclusions were based on figures derived from the studies conducted by American Management Association (AMA) of apparel/textile manufacturers adjusted for two standard deviations. According to all available survey reports reviewed by Mr. Brennan, no enterprise similar to petitioner's paid its chairman or president over the maximum reasonable figures noted above.

Ted S. Decker, a witness for petitioner, is an expert on compensation paid to executives by men's clothing and suit manufacturers.[11] He prepared written comparisons of Rutter Rex's total wages, salaries and bonuses to its sales with industry statistics from the American Apparel Manufacturers' Association (AAMA). We give little weight to Mr. Decker's opinion since we do not consider the comparisons made by Mr. Decker to be persuasive. His comparisons were primarily of salaries to sales which he, himself, testified had no direct relationship.

Petitioner's second expert, Donald R. Simpson, is a recognized expert in the executive compensation area and is a partner of Hay Associates, which is a consulting firm specializing in the area of human resources. Mr. Simpson's results are derived from use of the Hay Guide Chart--Profile Method of Job Evaluation (commonly called "the Hay system").[12] After interviewing Mr. Rutter and Mr. Eugene Rutter and visiting the offices and manufacturing facilities of Rutter Rex, Mr. Simpson evaluated the jobs of Mr. Rutter and Mr. Eugene Rutter, using the Hay method. Mr. Simpson then compared the pay of the Rutters to survey data from the Annual Hay Compensation Comparison for the years in issue and concluded that even though the pay of both Messrs. Rutter was higher than the range of pay practice of professionally managed industrial companies in the United States for the years in issue, he was justified in increasing the normal range by 100 percent for bonuses and 100 percent for "long-term incentives."

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[11] See Paramount Clothing Co., Inc. v. Commissioner, T.C. Memo. 1979-64 (Ted S. Decker recognized as expert).

[12] See Home Interior & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1156 (1980), wherein the "Hay method" is discussed.

Mr. Simpson in his report concluded that reasonable compensation for the Rutters should be as follows:

Year	James H. Rutter	Eugene J.Rutter
1976	$469,000	$364,000
1977	495,000	386,000
1978	530,000	415,000

Mr. Simpson, however, testified at trial that the "reasonable limit" of compensation for the Rutters, including salary and bonuses based on his various analyses, for the years at issue should be as follows:

Year	James H. Rutter	Eugene J.Rutter
1976	$229,100	$176,500
1977	249,600	183,800
1978	300,100	216,100

Mr. Simpson gave no creditable explanations of any reason why salaries paid to Mr. Rutter and Mr. Eugene Rutter should exceed these amounts other than Mr. Rutter's failure to be reimbursed for his travel expenses and the fact that Rutter Rex did not contribute to a pension or profit sharing plan for its officers. He talked in general terms of long-term incentives. However, he gave no specific data with respect to the extent that this element was included in his "reasonable limit" of compensation. Also, he produced no support for the claim that other companies used in his study generally had such long-term incentives or the value thereof. Particularly, he did not show any company comparable to Rutter Rex with a long-term incentive plan or what value should be placed on any such plan. With respect to pension and profit sharing plans, Mr. Simpson testified as follows:

> Q Did you take into account the presence or absence of pension and profit sharing plans?
>
> A The surveys that we are using ignore pension and profit sharing plans. The Rutter Rex Company does not have a pension plan, or a profit sharing plan, nor any of the capital accumulation plans. These can represent 10 to 25 percent of pay. If they had chosen to install thse plans, they could have diverted, if you will, that kind of pay level then from salary into special qualified plans.
>
> I was reluctant to make any quantification of that. In my judgment, the lack of existence of that plan is another reason why pay is within the range of reasonableness.

On this record a 25 percent addition to salary and bonuses for pension, profit sharing and capital accumulation is the highest permissible level. When this amount is added to the salary and bonuses Mr. Simpson testified to as "tops" for the Rutters, the following compensation for the years indicated results:

Year	James H. Rutter	Eugene J. Rutter
1976	$286,375	$220,625
1977	312,000	229,750
1978	375,125	270,125

There is nothing in this record from which we can determine what business travel expenses Mr. Rutter paid but did not collect from Rutter Rex. Since it was his choice not to be reimbursed, there is no reason to adjust his salary for any such item.

Based on the record as a whole, we conclude that the amounts set forth above, increasing the salary and bonuses of the Rutters as testified to by Mr. Simpson as the "reasonable limit" by 25 percent for pension, profit sharing or capital accumulation plans, represent reasonable compensation for them.

We have considered the numerous other arguments made by the parties, but do not consider it necessary to discuss them in detail since based on all the evidence in the record, with particular weight being given to part of Mr. Simpson's testimony, we have determined the amount of reasonable compensation for the Rutters.

It is clear from this record that the salaries the Rutters received were not negotiated at arm's length. Mr. Rutter was in a position to pay himself and his son whatever salary and bonus he chose, and any amount over and above reasonable compensation as determined previously paid to Mr. Rutter represents the distribution of a dividend to Mr. Rutter, and as a dividend is not limited to the maximum tax on earned income.

Accumulated Earnings and Profits Tax

An accumulated earnings tax is imposed upon "every corporation * * * formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * * by permitting earnings and profits to accumulate instead of being divided or distributed." Sections 532(a), 531. The corporate taxpayer has the burden of proving that the purpose of its accumulation was not a proscribed purpose. United States v. Donruss Co., 393 U.S. 297, 301 (1969). This is a question of fact. American Metal Products Corp. v. Commissioner, 287 F.2d 860, 864 (8th Cir. 1961), affg. 34 T.C. 89 (1960).

If earnings and profits are permitted to accumulate beyond a taxpayer's reasonable business needs, the presumption arises that the accumulation was to avoid payment of income tax by its shareholders and the burden is on the taxpayer to prove otherwise by a preponderance of the evidence. Section 533(a). See *United States v. Donruss Co.*, *supra* at 307; *Faber Cement Block Co. v. Commissioner*, 50 T.C. 317, 327 (1968).

As the Supreme Court pointed out in *Ivan Allen Co. v. United States*, 422 U.S. 617, 628 (1975), "the question, therefore, is not how much capital of all sorts, but how much in the way of quick or liquid assets, it is reasonable to keep on hand for the business." In this case the parties agree that liquid assets of petitioner at the end of each year exceeded the agreed amounts of accumulated earnings and profits at the beginning of the year. Although the reason for this situation is not explained, we accept the figures agreed to by the parties. When accumulated earnings in the form of liquid assets in excess of an amount necessary to meet the current and anticipated business needs of a taxpayer are available, the strong indication is that an additional accumulation of profits of the current year is beyond the reasonable needs of the business. *Atlantic Properties, Inc. v. Commissioner*, 62 T.C. 644, 656 (1974), affd. 519 F.2d 1233 (1st Cir. 1975); *Novelart Manufacturing Co. v. Commissioner*, 52 T.C. 794, 806 (1969), affd. 434 F.2d 1011 (6th Cir. 1970), cert. denied 403 U.S. 918 (1971); *John*

P. Scripps Newspapers v. Commissioner, 44 T.C. 453, 467-468 (1965); section 1.535-3(b)(1)(ii), Income Tax Regs.

In accordance with section 534(b), respondent notified Rutter Rex that he proposed to issue a notice of deficiency for the taxable years 1976, 1977, 1978, and 1979 which would include an amount with respect to the accumulated earnings tax imposed by section 531. Rutter Rex timely submitted a statement pursuant to section 534(c)[13] and thereafter respondent issued a notice of deficiency determining an accumulated earnings tax under section 531 of $446,658 for 1977 and $598,077 for 1978. The notice of deficiency determined no accumulated earnings tax for 1976 or 1979. Rule 142(e) provides that this Court will ordinarily rule prior to trial on whether a section 534(c) statement submitted by the taxpayer is sufficient to place the burden of proof on respondent pursuant to section 534(a)(2). In Rutter v. Commissioner, 81 T.C. 937 (1983), dismissed per order (5th Cir., Mar. 8, 1984), cert. denied 469 U.S. 980

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[13] Section 534(c) provides that "the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business," and if such a statement is submitted, section 534(a)(2) provides that the burden of proof shall be on the Commissioner with respect to the grounds set forth in such statement. Capital Sales, Inc. v. Commissioner, 71 T.C. 416, 435-436 (1978), revd. and remanded on another issue sub nom. Simon v. Commissioner, 644 F.2d 339 (5th Cir. 1981).

(1984), this Court held that Rutter Rex's section 534(c) statement failed to set forth facts sufficient to place the burden of proof on respondent with respect to all but two of the grounds set forth by petitioner. We held that petitioner's statement failed to set forth facts to show that the accumulations were needed (1) to supply working capital necessary to conduct normal business operations; (2) to replace and improve fixed assets; (3) to develop, produce and distribute products; (4) to provide preparedness in the event labor problems occur; and (5) to have funds available if new business was secured from the United States Government.

At the trial, petitioner moved for reconsideration of our holding in Rutter v. Commissioner, supra. That motion was denied. On brief, petitioner again argues that the burden of establishing grounds (1) through (5) set forth in its statement should be on respondent. This issue was disposed of in Rutter v. Commissioner, supra, and we again deny petitioner's request that we reconsider the holding in that case.

Working Capital Needs

Providing necessary working capital for the taxpayer's business constitutes a reasonable business need. Section 1.537-2(b)(4), Income Tax Regs.; Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 270 (1986); Doug-Long, Inc. v.

Commissioner, 72 T.C. 158, 176 (1979); Magic Mart, Inc. v. Commissioner, 51 T.C. 775, 791-793 (1969).

Petitioner may establish its working capital needs by any relevant, persuasive evidence. However, in many cases working capital needs have been determined by calculating a taxpayer's working capital needs for a single, complete operating cycle which will trace a taxpayer's application of cash, representing working capital, through the taxpayer's operations until it emerges again as cash. Generally, an operating cycle is the period of time needed to convert cash into raw materials, raw materials into finished goods, inventory into sales and accounts receivable, and accounts receivable into cash.[14]

The operating cycle approach is not a rule of law--"the Bardahl formula is an attempt to inject a degree of objectivity into a quantification of business needs; it is a tool to be used when helpful and its use is not mandated in all events." Thompson Engineering Co. v. Commissioner, 80 T.C. 672, 697 (1983), revd. on another point 751 F.2d 191 (6th Cir. 1985). See also Dielectric Materials Co v. Commissioner, 57 T.C. 587, 599 (1972).

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[14] This method has become known as the Bardahl formula from Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo. 1965-200. See also Alma Piston Co. v. Commissioner, T.C. Memo. 1976-107, affd. 579 F.2d 1000 (6th Cir. 1978); W.L. Mead, Inc. v. Commissioner, T.C. Memo. 1975-215, affd. 551 F.2d 121 (6th Cir. 1977).

Although, as hereinafter discussed, petitioner alternatively contends that the "Bardahl formula" is not appropriate for use in this case, both parties presented expert testimony of Rutter Rex's working capital needs by using the "Bardahl formula." The major differences in the computations are the length of the operating cycle and the use of the credit cycle by respondent's expert but not by petitioner's.

Petitioner's expert witness, John S. Furst, a C.P.A., prepared a Bardahl computation of Rutter Rex's working capital needs for the 1977 and 1978 taxable years. Mr. Furst computed the inventory cycle and accounts receivable cycle by using the average of the three highest consecutive inventory and accounts receivable months during the years 1977 and 1978.[15] The average three highest months for inventory were October, November and December in 1977 and

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[15] To support the application of the average of the three highest consecutive months in computing the inventory and receivable cycles, petitioner relies on State Office Supply, Inc. v. Commissioner, T.C. Memo. 1982-292. In that case, there was no evidence of a breakdown of the taxpayer's monthly amounts of inventory and accounts payable for the taxable year in issue which ended on August 31. We decided in view of all the evidence and testimony submitted that the taxpayer's business was cyclical in nature and that the ending balances of inventory and accounts receivable as of August 31 were extremely low. Using the best evidence available, we concluded that the taxpayer's accounts receivable should be adjusted upward to an amount equal to the average of the three highest consecutive months rather than the August 31 amount.

July, August and September in 1978. The average three highest months for accounts receivable for 1977 were January, February and March, and for 1978, September, October and November. Mr. Furst concluded that a 116.4-day cycle applied for 1977 and a 120.36-day cycle applied for 1978.

Mr. Furst did not use a credit cycle in his calculations because of his opinion that Rutter Rex's history of prompt payment of its accounts payable and lack of relationship to its suppliers made the use of a credit cycle unnecessary.

On brief, petitioner argues in the alternative that if we decide to reduce working capital needs by the credit cycle, we should not include accruals with the accounts payable. The accruals erroneously included, according to petitioner, were accrued Federal, State and City income taxes; accrued and unpaid salaries and wages; accrued city and state sales taxes; accrued Koratron royalties payable;[16]

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[16] Petitioner's financial statements make the following note regarding the accrued Koratron royalties payable:

2. ACCRUED KORATRON ROYALTIES PAYABLE:

Balance represents estimated amount of royalties payable based on 1% of the retail value of finished garments processed through the Koratron ovens. However, due to the many pending court cases filed to determine the effect of the patent agreement, management is of the opinion that the company's royalty liability will be limited. Accordingly, accrual of Koratron royalty payables was suspended in May of 1969.

payroll taxes payable; and a provision for employees' vacation pay.

Alternatively, petitioner argues that the Bardahl formula should not be applied at all in the instant case in view of the nature of Rutter Rex's business which petitioner notes is unpredictable, speculative, cyclical, depends on the receipt of contracts, and reaches highs and lows at different times of the year due to the uncertainty of when contracts will be received.

We recognize that this Court and other courts have rejected use of the Bardahl formula in computing the taxpayer's working capital needs in certain situations. Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429 (10th Cir. 1974), affg. a Memorandum Opinion of this Court; Ready Paving & Construction Co. v. Commissioner, 61 T.C. 826 (1974); Sandersville Railroad Co. v. United States, 385 F.Supp. 59 (M.D. Ga. 1974).[17] We find those cases to be distinguishable from this case. The cases rejecting the Bardahl formula involved taxpayers whose income was bunched in just a few months as a result of contracts of relatively long duration. In addition, in several of those cases we concluded that the *Bardahl* formula was inappropriate in service businesses such as newspaper publishing, railroads and contractors that have no tangible inventory. In our view, the application of the *Bardahl* formula to compute working capital needs in the instant case is appropriate because Rutter Rex is a manufacturing business with tangible inventory and an identifiable working cycle. It is not a service business and a review of the month-end accounts receivable and inventory reveals that its income is dispersed throughout the entire year rather than bunched in a few months. Furthermore, petitioner has produced no persuasive evidence of its working capital needs aside from a computation of its needs for one business cycle which may be computed under the *Bardahl* formula.

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[17] See also Thompson Engineering Co. v. Commissioner, 80 T.C. 672, 697 (1983), revd. on another point 751 F.2d 191 (6th Cir. 1985) (Bardahl formula held to not appropriately measure the business needs of a mechanical contractor whose business lacked a routine operating cycle); EMI Corp. v. Commissioner, T.C. Memo. 1985-386; Delaware Trucking Co. v. Commissioner, T.C. Memo. 1973-29.

Respondent's expert, Gustav A. Gomprecht, a C.P.A., also prepared a computation of the working capital needs of petitioner, using the *Bardahl* formula. He calculated the operating cycle for each year in issue by computing the inventory cycle plus accounts receivable cycle less the credit cycle. He added each month's inventory and receivables figures, subtracted each month's accounts payable, and used the highest monthly resulting figure for each year to establish the point in time during that year when the taxpayer's needs for operating funds are the highest. Respondent supports this so-called "net peak method" of determining the operating cycle for purposes of the Bardahl formula by arguing that it is based on "undisputed financial data." Mr. Gomprecht computed petitioner's operating business cycle for 1977 to be 78.83 days and for 1978 to be 85.70 days. Mr. Gomprecht determined March to be the month with the greatest business needs in 1977 and September to be the month with the greatest needs in 1978.

Respondent contends that an essential component of the manufacturing operating cycle is the credit cycle. Respondent argues that business operations dictate that the period of time extended to a company to pay for its inventory is properly reflected as a reduction to the period of time its cash is tied up in inventories and accounts receivable. Respondent cites Doug-Long, Inc. v. Commissioner, 72 T.C. at 177; Ready Paving & Construction Co. v. Commissioner, 61 T.C. 826, 835 n. 8 (1974).

The courts have generally focused on the taxpayer's peak month operating cycle needs and in some instances on yearly averages, rather than on the three consecutive months that produced the highest average as advanced by petitioner's expert, Mr. Furst. See Snow Manufacturing Co. v. Commissioner, supra. The rationale for the use of the "peak" inventory and receivables month is that a business should provide for the heaviest demands on its funds which generally would be its "peak" month's needs.[18]

While some cases have used an addition of monthly inventory and receivables to determine the peak month, other cases have determined these peaks separately and then added the number of days in each resulting cycle. Cases which have used the average method have approved yearly averages and not three high month averages as proposed by petitioner's expert. We do not consider the three high month averages used by petitioner's expert to be an acceptable method in this case. The months used for inventories and for accounts payable are different months.

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[18] As this Court stated in Bardahl International Corp. v. Commissioner, T.C. Memo. 1966-182, 25 T.C.M. 935, 945-946, 35 P-H Memo T.C. par. 66,182, p. 1062-1063 (1966):

> Second, we agree with petitioner that reasonably prudent businessmen, in considering the cash needs of a business such as this, would take into consideration the fact that the business had peak periods during the year when cash was tied up in inventory and receivables for longer periods than usual, and would be justified in accumulating sufficient net liquid assets to meet the needs of the business during this peak period, rather than just an average operating cycle. It is true that determining the reasonable cash needs of a business by this approach involves somewhat of an averaging concept and it is apparent from an analysis of the turnover of petitioner's inventories and receivables that to use the peak month each year rather than the average for the entire year will distort the picture of the cash needs of this business during most of the time, but we cannot say that making provision for such a peak period would be unreasonable or unlikely on the part of the officers and directors of this corporation in determining the reasonable needs of its business.

See also Marie's Shoppe, Inc. v. Commissioner, T.C. Memo. 1977-381; Walton Mill, Inc. v. Commissioner, T.C. Memo. 1972-25.

Therefore, the method used by petitioner's expert is not geared to any one time of greatest need.

However, we have computed petitioner's working capital needs by using yearly averages and also by using petitioner's expert's computations adjusted on his method for a credit cycle and respondent's expert's computations adjusted to remove from accrued expenses the accrual for Koratron royalties.[19] From our computations, it is apparent that the primary issues to be decided in this case are the appropriateness of use of the credit cycle and what business needs Rutter Rex had in addition to working capital needs.

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[19] Appendix A is a computation based on yearly averages for the inventory cycle, the accounts receivable cycle and the credit cycle. In Appendix A, one credit cycle is determined based only on material costs and accounts payable and another on all operating expenses and accounts payable plus accruals. Since this record is not clear whether "accounts payable" are only trade accounts payable properly comparable to material cost, we consider the use of accounts payable plus accruals divided into all operating costs more appropriate.

In Appendix B, we have used the calculations of petitioner's expert adjusted by reducing the inventory and receivables cycles by a credit cycle. We use a credit cycle of all operating costs divided by accounts payable plus accruals excluding the Koratron royalties. For accounts payable we use the average of the three lowest months since this is compatible with using the average of the three highest months for the inventory and receivables cycles. In each instance the business needs for one operating cycle are less than the accumulated earnings at the beginning of the year. After adding the amounts for expenditures for physical properties, it is $6,501,816 for 1977, which is approximately $1,800 greater than accumulated earnings at the beginning of that year, and is $6,695,273 for 1978, which is less than accumulated earnings at the beginning of that year.

We have recomputed the calculations of respondent's expert Mr. Gomprecht in Appendix C excluding the accrual for Koratron royalties in each of the years 1977 and 1978 of $184,495. This computation results in total working capital

(footnote continued)

In many cases where working capital needs have been determined by use of the Bardahl formula, the combined inventory and receivables cycle has been reduced by the credit or payables cycle. Doug-Long Inc. v. Commissioner, 72 T.C. at 176, and cases there cited. This cycle is the average amount of time during which the corporation's accounts payable are outstanding. The underlying theory is that new inventory will be used to start the operation cycle as soon as it is received, but will not require a cash outlay until a subsequent time when the accounts payable are actually paid.[20] As a result, a company's actual cash requirements are reduced to the extent that payment for inventory received is delayed. Generally, the availability

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(footnote continued from previous page)
needs including expenditures for physical properties in 1977 and 1978 of $5,617,1231 and $6,525,348, respectively.

[20] In Grob, Inc. v. United States, 565 F. Supp. 391, 397 (E.D. Wis. 1983), the District Court for the Eastern District of Wisconsin provided the following rationale for reducing the operating cycle by the credit cycle:

> Those sources from which a corporation acquires its inventory and its labor do not get paid immediately. To the extent that such payments are delayed there should be some reduction in the cycle, since to this extent the taxpayer is operating on somebody else's money and does not need to utilize his own working capital.

of credit is a relevant factor in determining the working capital needs that a prudent businessman would consider. To the extent that payment of expenses may be postponed as a result of credit arrangements, the need for operating capital is reduced. See Atlas Tool Co. v. Commissioner, 70 T.C. 86, 116 (1978), affd. 614 F.2d 860 (3d Cir. 1980), cert. denied 449 U.S. 836 (1980). If in fact credit is extended to and used by a taxpayer, the failure to take credit arrangements into consideration results in overstating the amount of operating capital needed for a business cycle.

In the present case the record shows that most of petitioner's material purchases were "net 30 days" or "net 60 days". However, Mr. Eugene Rutter testified that even though 30 to 60 days' credit was available to petitioner, it was his practice during the years here in issue to always take advantage of discounts offered by inventory suppliers for immediate cash payments. For this reason, petitioner contends that reduction of the operating cycle by a credit cycle is not proper in this case. The record does not show on what percentage of its purchases petitioner received a discount for payment in less than the 30- or 60-day period. Also, an examination of petitioner's balance sheets shows that petitioner did not pay all expenses immediately. For instance, at the end of 1977 under current liabilities

$664,825 is listed as accounts payable. At the end of 1978 and 1979, $725,913 and $434,380, respectively, are listed as accounts payable. These figures are listed as current liabilities and indicate that petitioner does not pay all expenses immediately. We do not find persuasive petitioner's argument that these figures represent bills that were received by Rutter Rex shortly before the end of the year and that the bills were promptly paid by Rutter Rex in the beginning of the following calendar years. The record shows that Rutter Rex had accounts payable at the end of each month for each of the years here involved. The record does not support petitioner's argument that the payables at yearend represented bills received only in December of either 1977, 1978 or 1979. Petitioner's C.P.A., Michael J. O'Rourke, testified that Rutter Rex purchased supplies and materials in the approximate yearly amount of $12 million.[21] If petitioner had received the alleged 10 percent discount for prompt payment of all these invoices, it would have received discounts in the yearly amount of $1,200,000. If it had received discounts only on items shown on its financial statement as materials and supplies purchased, it would have received discounts of around $500,000 a year. The record reflects the receipt of discounts much lower than these amounts. In 1977, Rutter Rex earned discounts only in the amount of $117,988 and in 1978 in the amount of $114,352. It appears that in some instances petitioner received a discount if the bill was paid in 30 to 60 days.

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[21] Our computations from the financial statements show purchases of materials and supplies only in 1977 of $5,816,071 and in 1978 of $4,822,624. There may have been supplies other than those listed on the financial statement purchased, but if so, the record does not permit segregation of the items.

In an effort to support its position, petitioner introduced some invoices for each year which showed payment within 7 days of receipt of the invoice. The testimony was that these invoices were 32 to 35 percent of all invoices. However, they do not represent 32 to 35 percent of total purchases. The record as a whole clearly shows that petitioner did have substantial accounts payable at all times during the years here in issue and also had other accrued but unpaid expenses and that this factor must be considered in determining its need for working capital.

Petitioner's reliance on Atlas Tool Co. v. Commissioner, supra, to support its failure to include the credit cycle in the Bardahl formula is misplaced. In Atlas Tool, the taxpayer financed most of its imported inventory with letters of credit which required cash payment 2 to 3 weeks before rather than after receipt of the inventory from the carrier. The letters of credit thus had the reverse effect of buying on credit and accordingly we concluded that no reduction of the inventory and receivables cycle should be made for a credit cycle. The Court of Appeals for the Third Circuit agreed with our decision to make no reduction for an accounts payable turnover period. 614 F.2d at 869. In the instant case, however, Rutter Rex's bills remained unpaid for at least a portion of petitioner's working cycle and this credit cycle should thus be taken into consideration in computing working capital needs by the Bardahl formula.

Mr. Gomprecht used the one month in each year which showed the highest amount of inventory plus accounts receivable less accounts payable.[22] The theory of Mr. Gomprecht's computation is that this month is the one time of the year when petitioner had its highest need for funds. On the facts of this case, we consider Mr. Gomprecht's computations of petitioner's working capital needs to be the most accurate available and therefore accept them subject to the adjustment of eliminating the Koratron royalties from accounts payable plus accruals. However, using a yearly average for inventories, accounts receivable and accounts payable does not produce a different result, nor does using petitioner's expert's method adjusted for a credit cycle produce a substantially different result. See Appendixes A, B and C.

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[22] The computation made by Mr. Gomprecht follows almost to the letter the preferred computation suggested in Lewis, "Accumulated Earnings Tax," 35-6 Tax Mgmt. (BNA 1981). Although, as recognized in the article, there is disagreement in the decided cases on many aspects of the preferred method he suggests, there is logic in many of his suggestions.

The parties agree on brief and we also conclude that the accrual for Koratron royalties payable used by Mr. Gomprecht in his computation should not be reflected as an accrued liability but rather as a long-term liability and thus should be deleted from the credit cycle computation and we have recomputed Mr. Gomprecht's credit cycle deleting this item. See Appendix C. The other accruals which Mr. Gomprecht included with accounts payable as an extension of credit appear on this record to be proper if the credit cycle is to be computed by dividing the credit extended into total operating costs. Clearly, salaries and wages, payroll taxes, sales taxes and provision for employee vacation pay are a part of operating costs. If these amounts have been accrued, they are included in operating costs, and as unpaid accrual accounts are an extension of credit as much as unpaid accounts payable. In Doug-Long v. Commissioner, 72 T.C. at 176, we held that a taxpayer's estimated tax payments should be included in operating costs. If such payments are part of operating costs, accrued but unpaid taxes are effectively extensions of credit to be included with accounts payable when the credit cycle is computed by dividing total operating costs by extensions of credit. If only trade accounts payable are used as a credit extension in determining the credit cycle, the amount into which it should be divided is total costs of materials and supplies. This amount is not readily ascertainable from this record. In any event, a more accurate method is to use all extensions of credit which include accruals.

Petitioner's net liquid assets as of December 31, 1977 and December 31, 1978 were $7,329,170 and $8,151,306, respectively. Both petitioner's net liquid assets at the close of each year here in issue and its accumulated earnings at the beginning of each of the years here in issue exceed its working capital needs for one operating cycle computed on the best method for use in this case. Also, the other evidence in the record, particularly the amount of cash and cash equivalents petitioner had on hand at the beginning of each month of 1977 and 1978, supports this conclusion. We therefore must consider the extent to which petitioner had other reasonable business needs for which to accumulate its earnings and profits in these years.

Other Reasonable Business Needs

A taxpayer's reasonable business needs include its reasonably anticipated business needs. Section 537(a)(1). Section 1.537-1(b)(1), Income Tax Regs., provides:

> In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

In a closely held corporation, the type of corporation normally involved in an accumulated earnings case, it is not necessary that the "specific, definite, and feasible" plans alleged to support the accumulation be inscribed in formal minutes. Doug-Long, Inc. v. Commissioner, 72 T.C. at 171; John P. Scripps Newspapers v. Commissioner, 44 T.C. 453, 469 (1965). The taxpayer need not produce meticulously drawn formal blue prints for action. Faber Cement Block Co. v. Commissioner, 50 T.C. at 332; John P. Scripps Newspaper v. Commissioner, 44 T.C. at 469; Snow Manufacturing Co. v. Commissioner, 86 T.C. 260 (1986). It is not sufficient, however, for the corporation to merely recognize a future need and discuss possible and alternative solutions concerning the same. Atlantic Commerce & Shipping Co. v. Commissioner, 500 F.2d 937, 940 (2d Cir. 1974), affg. a Memorandum Opinion of this Court; Estate of Lucas v. Commissioner, 71 T.C. 838, 853 (1979), affd. 657 F.2d 841

(6th Cir. 1981). Definiteness of the plan coupled with action taken toward the consummation thereof are essential. Dixie, Inc. v. Commissioner, 277 F.2d 526, 528 (2d Cir. 1960), affg. 31 T.C. 415 (1958), cert. denied 364 U.S. 827 (1960); Estate of Lucas v. Commissioner, 71 T.C. at 853. In other words, "The intention claimed must be manifested by some contemporaneous course of conduct directed toward the claimed purpose." Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 202 (4th Cir. 1957), affg. in part a Memorandum Opinion of this Court, cert. denied 354 U.S. 922 (1957). The test is a practical one; namely, whether the alleged plan appears to have been "a real consideration during the taxable years, and not simply an afterthought to justify challenged accumulations." See Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495, 499 (4th Cir. 1960), affg. a Memorandum Opinion of this Court, cert. denied 354 U.S. 922 (1957); Faber Cement Block Co. v. Commissioner, supra at 332-333; Snow Manufacturing Co. v. Commissioner, supra.

Petitioner argues that all or part of its earnings and profits for the years 1976 through 1979 were not permitted to accumulate beyond the reasonable needs of its business because (1) the accumulation of earnings and profits was necessary to meet the needs for working capital needed to conduct the normal operations of its business, including the need to meet its obligations under its contracts with its customers; (2) the earnings and profits were needed for the replacement and improvements to its fixed assets; (3) the accumulation was necessary to provide funds for the development, production, and distribution of its products; (4) the accumulation was necessary to provide funds in the event of disruptions in its business resulting from labor disputes; and (5) the accumulations were necessary to have funds available in the event it entered into expected supply contracts with the United States Government as a result of on-going litigation.

Relying on section 537(a)(1) respondent argues that petitioner did not have specific, definite and feasible plans for the use of its accumulated earnings and profits.

Respondent contends that the instant case is similar to Barrow Manufacturing Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961), affg. a Memorandum Opinion of this Court. Barrow involved a garment manufacturing business which had grown steadily since its inception in the 1930s. The alleged plan in Barrow was to expand, but the Court found the plan to be very general and noted that the proposed implementation of the plan was indefinite and would not be completed within the reasonably calculable future. Here, as in the Barrow case, petitioner's hypothetical possibilities, indefinite plans, and unforeseen contingencies do not justify the accumulation of earnings and profits.

Although the minutes of petitioner's corporate board of directors meetings reveal petitioner's intent to "hold cash in readiness for when the time is ripe," no definite plans to expand with details such as site selection, costs or building plans are mentioned. The need to buy or replace its sewing machines with new electronic machines costing "many hundreds of thousands of dollars" is mentioned by the directors at the January 3, 1977 meeting, but no date of purchase is suggested. By the December 20, 1979 meeting, none of these machines had been purchased. The directors emphasized the need to proceed slowly with the purchases at the January 4, 1978, and December 29, 1978, meetings but by the December 20, 1979, meeting they had concluded not to expend the funds at all. They decided on December 20, 1979 that "all possible efforts be made to accumulate cash and other liquid assets."

The need to purchase small planes was also mentioned at the meeting on January 3, 1977, but by January 4, 1978, the planes had not been purchased and specific plans to do so had not been made.

The record fails to demonstrate that petitioner had a realistic expectation of expansion or of purchasing the new equipment discussed at the board of directors' meetings with the exception of its ordinary yearly equipment acquisitions as hereinafter discussed. Petitioner's "plans" for the accumulated capital amount to no more than mere possibilities at some indefinite future date. Such nebulous "plans" fail to provide a justification for the accumulation of earnings and profits where earnings retained from prior years are otherwise sufficient to meet the reasonable needs of the business. *GPD, Inc. v. Commissioner*, 60 T.C. 480, 495 (1973), revd. and remanded on other grounds 508 F.2d 1076 (6th Cir. 1974); *Barrow Manufacturing Co. v. Commissioner*, *supra*. Despite petitioner's "plans to spend funds for new equipment," the record reflects that in 1977, 1978 and 1979, petitioner made only the following expenditures for physical properties:

	Year Ended Dec. 31		
	1977	1978	1979
Leasehold Improvement	—	—	$357,637
Machinery and Equipment	$357,262	$130,788	385,942
Furniture and Fixtures	6,047	10,939	3,107
Warehouse Equipment	4,662	8,510	30,653
Floating Equipment	15,181	8,565	42,000
Automotive Equipment	195,120	41,863	56,598
Total	$578,272	$200,665	$875,937

Petitioner clearly did not expend the enormous sums it would have us believe it had plans in 1977 and 1978 to spend. Certainly, this record is clear that petitioner had no definite or specific plans for such expenditures.

Petitioner argues that the accumulation of earnings and profits in 1977 and 1978 was necessary in order to provide funds for labor disputes. The record does not contain facts to support the likelihood of labor problems in the years here in issue or foreseeable future years. We do not find persuasive petitioner's estimates of the costs associated with a hypothetical labor strike. These estimates were prepared for the trial of this case rather than at the time the funds were allegedly accumulated for this purpose. The numerous cases involving Rutter Rex as a party in labor disputes relate primarily to the 1954 strike by the ACWA against petitioner and the NLRB orders of reinstatement and back pay. Additional lawsuits involved Rutter Rex's allegations challenging the Small Business Act's "set aside" regulations pertaining to Government contracts. There is no evidence of labor difficulties in either 1977 or 1978 or of reasonably anticipated labor difficulties. In fact, there is no evidence that petitioner experienced any significant labor problem subsequent to 1954. In addition, there is no evidence to support petitioner's purported need to accumulate funds in 1977 and 1978 to retrain employees in the event labor problems occurred. At trial, petitioner's labor attorney specifically stated that he recalled no labor controversies during the years 1976 to 1979.

Petitioner also argues that the accumulation was necessary to finance supply contracts it expected to enter into with the United States Government after winning on-going litigation. The evidence reflects no definite and specific need for the accumulation of working capital if the litigation should be successful and additional Government contract work should be available to petitioner. Furthermore, petitioner did not set aside any identifiable funds for this alleged need.

Petitioner's C.P.A., Mr. O'Rourke, prepared estimates of labor costs due to increase if the anticipated labor problems erupted at Rutter Rex. He also prepared estimates of the costs associated with loss of the Government contracts business. We do not consider these estimates helpful in determining whether petitioner needed to accumulate funds for these purposes in 1977 and 1978. Mr. O'Rourke's estimates were prepared only a week before trial and could not have been useful to petitioner in determining the need to accumulate funds for these purposes in 1977 and 1978.

Both Mr. Gomprecht and petitioner's expert added to petitioner's working capital needs amounts needed for normal machinery purchase. We agree with these experts that the amount of $200,665 in 1977 and of $875,937 in 1978 needed to be accumulated for this purpose. However, when these amounts are added to Mr. Gomprecht's computation of petitioner's working capital needs adjusted to eliminate the Koratron royalties, the resultant amount in each year is less than the accumulated earnings at the beginning of that year and net liquid assets at year's end. Even though we do not consider the computation of working capital needs of petitioner by its expert to be proper in this case, it should be pointed out that when the amounts for purchases of physical assets are added to the computation of petitioner's expert of working capital needs corrected to include a credit cycle, the total amount of business needs in 1977 exceeds the accumulated earnings at the beginning of the year by less than $1,800 and in 1978 is less than the accumulated earnings at the beginning of the year.

The fact that petitioner accumulated earnings and profits beyond the reasonable needs of its business creates a presumption that its earnings were accumulated to avoid taxes on its shareholders. There is no persuasive evidence in this record tending to overcome this presumption.

Petitioner's poor dividend history indicates a tax avoidance objective in accumulating earnings and profits. Section 1.533-1(a)(2), Income Tax Regs.; Snow Manufacturing Co. v. Commissioner, 86 T.C. at 281; Doug-Long, Inc. v. Commissioner, 72 T.C. at 181-182; Atlantic Properties Inc. v. Commissioner, 62 T.C. 644, 660 (1974), affd. 519 F.2d

1233 (1st Cir. 1975). From 1931 to 1980, petitioner paid dividends only three times. From the record as a whole, we conclude that the failure to pay dividends in the years here in issue was at least in part to avoid taxes on its shareholders.

In our view the evidence reflects petitioner's accumulation of earnings and profits for the purposeful avoidance of income tax on its shareholders. Thus we hold that during the taxable years in issue petitioner was availed of for the purpose of avoiding income tax to its shareholders by the distribution of taxable dividends and is thus liable for the section 531 tax.

Repairs and Maintenance Expenses

Corporate petitioner argues that the disallowed expenditures in the amount of $137,975 constitute repair and maintenance expenses that are currently deductible under section 162. Petitioner notes that section 1.162-4, Income Tax Regs., provides that the costs of repairs which merely keep the property in an ordinary, efficient operating condition are currently deductible. On brief, petitioner supports the deductibility of these expenditures by citing the work paper completed by revenue agent McConnell in his examination of corporate petitioner's return for tax year 1979. To support its position, petitioner relies on the revenue agent's characterization of the repair and maintenance expenditures as "repair expenses" rather than capital expenses. Petitioner adds that these expenses merely maintained the property in an ordinary, efficient operating condition and that it was thus entitled to treat them as deductible repair and maintenance expenses.

Respondent contends that petitioner has failed to present adequate proof to overcome the presumption of correctness attaching to his determination that the amount disallowed was for capital improvements. Respondent cites *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 858 (5th Cir. 1971), affg. on this issue 52 T.C. 971 (1969),[23] to support this view. Respondent argues that according to section 1.162-4, Income Tax Regs., and *Difco Laboratories, Inc. v. Commissioner*, 10 T.C. 660 (1948), expenditures for additions and improvements which prolong the life of property or increase its value are capital expenditures and may not be deducted as business expenses.

In *Difco Laboratories*, this Court addressed whether certain alterations and changes in the building used in the taxpayer's business were deductible as business expenses or were capital expenditures. We distinguished repairs, which are deductible in the year paid or incurred, from improvements, which must be capitalized, by citing Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926) as follows:

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[23] The Tax Court opinion in *Bayou Verret Land Co. v. Commissioner*, 52 T.C. 971 (1969), was a consolidation of several cases, as was our opinion in *Churchill Farms, Inc. v. Commissioner*, T.C. Memo. 1969-192. The taxpayers in *Churchill* appealed to the Court of Appeals for the Fifth Circuit sub nom. *Bayou Verret Land Co.* and the Tax Court's opinion in *Churchill* was affirmed by the Fifth Circuit in *Bayou Verret*.

> In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong it life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge while the other are additions to capital investment which should not be applied against current earnings. * * *

Section 1.162-4, Income Tax Regs., provides as follows:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

The expenditures in issue in the amount of $137,975 were made to add a lunch area, restrooms, and a loading and unloading ramp to petitioner's existing plants. In addition the interior of the facilities were painted and "fixed up." Clearly, the additions of the lunch room, restrooms and ramps to the plants constitute nondeductible capital expenditures that were more than merely keeping the property in an ordinarily efficient operating condition. These additions and improvements not only increased the value of the plants but also aided in adapting them to a different use. As Mr. Eugene Rutter testified at trial, the additions to the plants were designed to enable Rutter Rex to make a new item, panatela jeans for Levi. See Jones v. Commissioner, 24 T.C. 563 (1955), affd. 242 F.2d 616 (5th Cir. 1957); see also Honigman v. Commissioner, 55 T.C. 1067, 1081 (1971), affd. on this issue 466 F.2d 69 (6th Cir. 1972). It is necessary to take into consideration the purpose for which expenditures are made in order to determine whether such expenditures are capital in nature or constitute a current expense. Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471, 482 (1967).

The expenditures relating to painting the facility would qualify as a deductible repair if they were standing alone; however, when they are made as a part of an entire capital investment in the improved property, as they were in the instant case, they must be treated as a capital expenditure. Jones v. Commissioner, 242 F.2d 616, 619 (5th

Cir. 1957), affg. 24 T.C. 563 (1955); United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). In addition, it is impossible to determine from the evidence submitted what portion of the amount expended, if any, is attributable to deductible repairs. In the absence of such a segregation the deduction cannot be allowed and all expenditures must be capitalized. Tovrea Land & Cattle Co. v. Commissioner, 10 T.C. 90, 97 (1948); Modesto Lumber Co. v. Commissioner, 5 B.T.A. 598, 600 (1926). We sustain respondent's disallowance of $137,975 of petitioner's claimed deduction for repair and maintenance expenses.

Decisions will be entered under Rule 155.

APPENDIX A

Bardahl Formula Computation — 1977

Inventory Cycle

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \qquad \frac{\$20{,}924{,}970}{\$\ 4{,}140{,}824} = 5.05 \qquad \frac{365}{5.05} = 72.28 \text{ days}$$

Accounts Receivable Cycle

$$\frac{\text{Annual Net Sales}}{\text{Average Accounts Receivable}} \qquad \frac{\$25{,}013{,}767}{\$\ 1{,}959{,}380} = 12.77 \qquad \frac{365}{12.77} = 28.58 \text{ days}$$

Credit Cycle on Materials Purchases Only

$$\frac{\text{Annual Materials Purchases*}}{\text{Average Accounts Payable}} \qquad \frac{\$\ 5{,}816{,}071}{\$\quad 744{,}912} = 7.81 \qquad \frac{365}{7.81} = 46.73 \text{ days}$$

* Includes freight and drayage

Annual Materials Purchases - 1977	
$5,556,646	- Piece goods
50,605	- Buttons
28,642	- Labels
58,032	- Linings
116,106	- Thread
6,040	- Freight & drayage
$5,816,071	

Credit Cycle on Total Operating Expenses

$$\frac{\text{Total Operating Expenses}}{\text{Average Accounts Payable Plus Accruals}} \qquad \frac{\$24{,}235{,}196}{\$\ 1{,}615{,}100} = 15.00 \qquad \frac{365}{15.00} = 24.33 \text{ days}$$

APPENDIX A (Continued)

	Average
Days in inventory cycle	72.28
Days in accounts receivable cycle	28.58
	100.86
Days in credit cycle--materials cost only	-46.73
Days in operating cycle	54.13

$$\frac{54.13}{365} = 14.83\% \text{ of year}$$

Percentage times operating expenses for year	14.83% x $24,235,196 = $3,594,079

	$ 3,594,079
Expenditures for physical properties	200,665
Total working capital needs	$ 3,794,744

	Average
Days in inventory cycle	72.28
Days in accounts receivable cycle	28.58
	100.86
Days in credit cycle--accounts payable plus accruals	-24.33
	76.53

$$\frac{76.53}{365} = 20.94\% \text{ of year}$$

Percentage times operating expenses for year	20.94% x $24,235,196 = $5,074,850

	$ 5,074,850
Expenditures for physical properties	200,665
Total working capital needs	$ 5,275,515

APPENDIX A (Continued)

Bardahl Formula Computation — 1978

Inventory Cycle

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \quad \frac{\$19{,}368{,}152}{\$\ 4{,}159{,}272} = 4.66 \quad \frac{365}{4.66} = 78.33 \text{ days}$$

Accounts Receivable Cycle

$$\frac{\text{Annual Net Sales}}{\text{Average Accounts Receivable}} \quad \frac{\$24{,}399{,}675}{\$\ 1{,}947{,}991} = 12.53 \quad \frac{365}{12.53} = 29.13 \text{ days}$$

Credit Cycle on Materials Purchases Only

$$\frac{\text{Annual Materials Purchases*}}{\text{Average Accounts Payable}} \quad \frac{\$\ 4{,}822{,}624}{\$\quad 671{,}271} = 7.18 \quad \frac{365}{7.18} = 50.84 \text{ days}$$

* Includes freight and drayage

Annual Materials Purchases - 1978	
$4,333,052	- Piece goods
125,839	- Buttons
61,434	- Labels
151,632	- Linings
130,242	- Thread
20,425	- Freight & drayage
$4,822,624	

Credit Cycle on Total Operating Expenses

$$\frac{\text{Total Operating Expenses}}{\text{Average Accounts Payable Plus Accruals}} \quad \frac{\$23{,}655{,}106}{\$\ 1{,}862{,}113} = 12.70 \quad \frac{365}{12.70} = 28.74 \text{ days}$$

APPENDIX A (Continued)

	Average
Days in inventory cycle	78.33
Days in accounts receivable cycle	29.13
	107.46
Days in credit cycle--materials cost only	-50.84
Days in operating cycle	56.62

$$\frac{56.62}{365} = 15.51\% \text{ of year}$$

Percentage times operating expenses for year 15.51% x $23,277,345 =$ 3,610,316

	$ 3,610,316
Expenditures for physical properties	$ 875,937
Total working capital needs	$ 4,486,253

	Average
Days in inventory cycle	78.33
Days in accounts receivable cycle	29.13
	107.46
Days in credit cycle--accounts payable plus accruals	-28.74
	78.72

$$\frac{78.62}{365} = 22\% \text{ of year}$$

Percentage times operating expenses for year 22% x $23,655,106 = $5,204,123

	$5,204,128
Expenditures for physical properties	875,937
Total working capital needs	$6,080,065

APPENDIX B

Subtract credit cycle from petitioner's expert's results with credit cycle computed using accounts payable plus accrued expenses (minus Koratron royalties). Accounts payable are computed using the average of the lowest consecutive three months during the year.

Computation of Credit Cycle

	1977	1978
Accounts payable (average of 3 lowest consecutive months--Jan., Feb., Mar. each year)	$ 548,149	$ 553,209
Accruals	870,188*	1,190,590**
	$ 1,418,337	$ 1,743,799
Operating expenses	$\frac{\$24,235,196}{\$\ 1,418,337} = 17.09$	$\frac{\$23,277,345}{\$\ 1,743,799} = 13.35$
Credit cycle turnover	$\frac{365}{17.09} = 21.36$ days	$\frac{365}{13.35} = 27.34$ days
Add days in inventory and accounts receivable cycles (from petitioner's expert's exhibit)	116.40 days	120.36 days
Subtract credit cycle	-21.36	-27.34
	95.04	93.02
Divide by 365	26%	25%
Multiply by operating expenses for year	$24,235,196	$23,277,345
Working capital needs for one cycle	$ 6,301,151	$ 5,815,336
Add expenditures for physical properties	200,665	875,937
	$ 6,501,816	$ 6,695,273

* Accruals 1977
$1,054,683 - 1977 Accruals
-184,495 - Koratron royalties
$ 870,188

** Accruals 1978
$1,375,085 - 1978 Accruals
-184,495 - Koratron royalties
$1,190,590

APPENDIX C

Recalculation of Mr. Gromprecht's Bardahl Computation Excluding the Koratron Royalties from Accruals in the Credit Cycle

1977

Accounts payable	$ 762,027
Accruals	870,188*
	$1,632,215 - Total payables for calculating credit cycle minus Koratron royalties

* $1,054,683
-184,495 - Koratron royalties
$ 870,188

$$\frac{\$\ 1,632,215}{\$24,235,196} \times 365 = \text{credit cycle turnover 24.58 days}$$

Add inventory cycle plus accounts receivable cycle and deduct credit cycle:

68.16 days in inventory turnover
38.03 days in accounts receivable turnover
106.19
-24.58
81.61 days -- divide by 365 = operating cycle expressed as percentage of year -- 22.35%

Multiply by operating expenses - $24,235,196

Working capital needs for one cycle	$5,416,566
Expenditures for purchases of physical properties	200,665
Total working capital needs including expenditures for physical properties	$5,617,231

APPENDIX C (Continued)

1978

Accounts payable	$ 790,252
Accruals	1,190,590*
	$1,980,842 - Total payables for calculating credit cycle minus Koratron royalties

*$1,375,085
-184,495 - Koratron royalties
$1,190,590

$\frac{\$\ 1,980,842}{\$23,277,345}$ x 365 = credit cycle turnover 31.06 days

Add inventory cycle plus accounts receivable cycle and deduct credit cycle:

83.10 days in inventory turnover
36.55 days in accounts receivable turnover
119.65
-31.06
88.59 days — divide by 365 = operating cycle expressed as percentage of year — 24.27%

Multiply by operating expenses - $23,277,345

Working capital needs for one cycle	$5,649,411
Expenditures for purchases of physical properties	875,937
Total working capital needs for 1978 including expenditures for physical properties	$6,525,348

COMPLETED
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JU11.7/2: 1986-408

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T. C. Memo. 1986-408

ORIGINAL

UNITED STATES TAX COURT

ESTATE OF MARY R. SPENCER, Deceased, C/O CHARLES H. SPENCER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

CHARLES H. SPENCER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 106-84,
114-84.

Filed September 2, 1986.

During 1976, P formed the Greenville Church of the Commandments and purportedly transferred all of his income and assets to the church. P filed no income tax returns for 1976 and 1977 and made several attempts to conceal or prevent an examination of his financial records. Held, P's conduct constituted fraud within the meaning of sec. 6653(b), I.R.C. 1954.

Joe Alfred Izen, Jr., for the petitioners.

James E. Polk, for the respondent.

G.M./VL

MEMORANDUM FINDINGS OF FACT AND OPINION

SIMPSON, Judge: The Commissioner determined deficiencies in, and additions to, the petitioners' Federal income taxes as follows:

			Additions to Tax			
Petitioner	Year	Deficiency	Sec. 6651(a) I.R.C. 1954[1]	Sec. 6653(a) I.R.C. 1954	Sec. 6653(b) I.R.C. 1954	Sec. 6654 I.R.C. 1954
Estate of Mary R. Spencer	1976	$ 3,594.00	$898.50	$179.70	—	$ 134.14
Charles H. Spencer	1976	$34,065.84	—	—	$17,032.92	$ 1,271.34
	1977	$88,188.00	—	—	$44,094.00	$ 3,128.92

Most of the issues in this case have been conceded by the petitioners; the only issue remaining for decision is whether the petitioner Charles H. Spencer is liable for the additions to tax under section 6653(b) for fraud.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.[2]

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

[2] The petitioners in their brief in answer failed to set forth any objections to the Commissioner's requested findings of fact. Because of the failure to comply with Rule 151(e)(3), Tax Court Rules of Practice and Procedure, the Commissioner requests that we adopt his requested findings. We decline to do so, but we will base our findings of fact upon the evidence and testimony of record.

The petitioner, Charles H. Spencer, maintained his residence in Greenville, Tex., at the time of filing his petition in this case. Mary R. Spencer (the decedent) and Charles H. Spencer were married and resided in the State of Texas from January 1, 1976, until her death on June 9, 1976. The executor of her estate is Dr. Spencer. He will sometimes be referred to as the petitioner.

The petitioner attended medical school at the University of Virginia and practiced general medicine for several years. He then went to Dallas to receive training in the specialty of radiology; thereafter, he went into practice in Greenville, Tex. In Greenville, the petitioner performed his services as a physician and radiologist through his wholly owned corporation, Spencer Radiology Association (the association). On July 1, 1971, the association entered into a written agreement to provide radiology services for the Greenville Hospital District. This agreement remained in force until January 1, 1976. Sometime in 1976, the petitioner liquidated the association.

Prior to 1976, the petitioner filed proper income tax returns, both in his individual capacity and as president of the association. For 1973 through 1975, he utilized a certified public accountant to prepare and file such income tax returns. In late 1975 or early 1976, the petitioner requested that the accountant return his income tax records. The petitioner's purpose for demanding these records was to prevent the Internal Revenue Service from obtaining information concerning his tax-related activities.

The petitioner filed no Federal income tax returns for 1976 and 1977 for himself; nor did he file a Federal income tax return for the decedent for 1976. In 1982, the petitioner entered a plea of guilty for the willful failure to file his income tax return for 1977. He served a 9-month sentence for such crime. After he was released, he filed "Fifth Amendment" returns for 1976 through 1980; on each such return, he claimed the Fifth Amendment and included no information concerning his income or deductions.

On January 9, 1976, the petitioner filed articles of incorporation with the State of Texas for the Greenville Church of the Commandments (the church). According to such articles, the church was established as a non-profit organization for the purposes of maintaining a church of gospel, providing places of public meditation, maintaining and conducting a school for religious instruction of children and adults, establishing and maintaining libraries, reading rooms, and book stores for the sale of publications relating to the teaching of the church, establishing rest homes for the elderly, orphans, and others, supporting religious matters in the evangelization of the world, and other things. However, the petitioner never intended his church to serve such purposes. The church had no congregation, no members (other than the petitioner, his wife, and his daughter), no regular worship services, and no sacramental services wherever performed. The petitioner's wife and daughter were ill, and he claimed that by establishing the church he could save taxes and use the funds of the church to care for his wife and daughter.

On January 7, 1976, the petitioner filed the vow of poverty with the County Clerk's office of Hunt County, Texas, and on February 19, 1976, he filed a quit claim deed with the same office. In the quit claim deed, the petitioner purported to assign all of his interest in his residence to the church. The petitioner's vow of poverty purported to require him to transfer all of his earthly possessions to the church and all income thereafter; it also required the church to take care of his "temporal needs." After filing these documents and making the purported contributions and donations to the church, the petitioner continued living in his home and began paying all of his personal expenses out of the church's funds and assets. The petitioner admittedly had unfettered control over all the assets purported to have been given by him to the church. In fact, the petitioner was able to transfer funds from the checking account of the church in the amount of $79,000 to a Swiss bank during 1977; he claims that such funds have now been "lost."

After 1975, the petitioner changed his form of carrying on his business; thereafter, he performed his services for the Greenville Hospital District as an individual. The checks in payment for his services were deposited into the checking account of the church.

The petitioner paid several individuals to advise him on how to establish his own "church." These individuals also described the tax advantages which they claimed that he could secure by creating the church. The petitioner was told that the use of checks printed on red paper would conceal the financial activities of the church, since the bank could not make copies and keep records of them. For a time, he used such red checks to conceal the financial activities of the church, but the bank did not allow him to continue to use them.

On his Federal income tax return for 1975, the petitioner claimed a charitable contribution deduction in the amount of $21,750.00 for a 1974 "maule" aircraft allegedly donated to the church. He claimed that the aircraft cost $31,965.80 in 1974, but his actual cost of the aircraft was only $21,000.00. In 1974, he borrowed $18,000 from Citizens National Bank of Greenville to procure a cashier's check which was used to purchase such aircraft. The petitioner repaid the $18,000 loan on February 5, 1976, with a cashier's check obtained with funds withdrawn from the checking account of the church. On March 23, 1976, the petitioner also withdrew $9,660 from the church's checking account to procure the cashier's check used to pay another loan made to him on January 17, 1974.

In his notice of deficiency, the Commissioner determined that Dr. Spencer received total income in the amount of $97,173 in 1976 and $179,652 in 1977. The Commissioner determined that the income earned in 1976 was community income for the period Mrs. Spencer was living, and therefore he allocated $79,589 to the petitioner as his share of the community income for 1976. The Commissioner also determined that Dr. Spencer was liable for the addition to tax for fraud under section 6653(b) for 1976 and 1977 and that he was liable for the addition to tax under section 6654 for failure to pay estimated taxes for such years. In his notice of deficiency issued to the Estate of Mary R. Spencer, the Commissioner determined that the decedent received community income in the amount of $17,584 during 1976. In addition, he determined that the estate was liable for the addition to tax under section 6651(a) for failure to file a return, the addition under section 6653(a) for underpayment of tax due to negligence or intentional disregard of rules and regulations, and the addition under section 6654(a) for underpayment of estimated taxes.

OPINION

The petitioners have the burden of proving that they are not liable for the deficiencies determined by the

Commissioner. Rule 142(a), Tax Court Rules of Practice and Procedure[3]; Welch v. Helvering, 290 U.S. 111, 115 (1933). They also have the burden of proving that they are not liable for the additions to tax under sections 6651(a), 6653(a), and 6654(a). Abramo v. Commissioner, 78 T.C. 154, 163 (1982) (sec. 6651(a)); Bixby v. Commissioner, 58 T.C. 757 (1972) (sec. 6653(a)); Mitchell v. Commissioner, 51 T.C. 641, 648 (1969), revd. 430 F.2d 1 (5th Cir. 1970), revd. 403 U.S. 190 (1971) (sec. 6654). The petitioners presented no evidence or arguments to refute the Commissioner's determinations with respect to the deficiencies and the additions to tax under sections 6651(a), 6653(a), and 6654(a). They apparently intend to concede all such issues, and in any event, we must sustain the Commissioner's determinations with respect to such issues since the petitioners have failed to carry their burden of proof.

The only issue remaining for decision by the Court is whether Dr. Spencer is liable for the addition to tax for fraud. Section 6653(b) provides that if any part of any underpayment is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment.

The Commissioner bears the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b); Levinson v. United States, 496 F.2d 651, 654-655 (3d Cir.

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[3] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

1974); Miller v. Commissioner, 51 T.C. 915, 918 (1969). This burden will be carried by the Commissioner if he shows that the taxpayer intended to evade taxes which he knew or believed that he owed by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Acker v. Commissioner, 26 T.C. 107, 111-112 (1956).

The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Grosshandler v. Commissioner, 75 T.C. 1 (1980); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed, but rather must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may be inferred from any conduct, the effect of which would be to mislead or conceal the existence of a tax liability. Spies v. United States, 317 U.S. 492, 499 (1943). Circumstantial evidence is permitted where direct evidence of fraud is not available, and fraud may be inferred where an entire course of conduct establishes the necessary intent. Rowlee v. Commissioner, 80 T.C. 1111 (1983); Stone v. Commissioner, 56 T.C. 213 (1971). Evidence of prior and subsequent similar acts reasonably close to the years at issue may be considered. United States v. Johnson, 386 F.2d 630, 631 (3d Cir. 1967).

In the present case, the evidence in the record clearly and convincingly establishes that the petitioner's underpayment of income taxes for 1976 and 1977 was due to fraud. He testified that he and his family found the established churches to be unsatisfactory. However, the alleged dissatisfaction with the religious services of the established churches does not explain or justify the petitioner's creation of his own church and the purported transfer of his assets and income to that church. He admitted that, at least in part, he established the church and transferred his income and assets to it to secure tax exemption. He sought to justify his objective of seeking tax savings by the fact that he had unusually heavy family obligations; nevertheless, his testimony makes clear that his arrangements were designed to avoid the payment of taxes. In fact, he continued to exercise complete control over his income and assets, and he continued to use them for the benefit of himself and his family. Thus, we find that the creation of the church and the purported transfer of income and assets to it was a sham undertaken to avoid the payment of taxes on his income. See Stephenson v. Commissioner, 79 T.C. 995 (1982), affd. per curiam 748 F.2d 331 (6th Cir. 1984); McGahen v. Commissioner, 76 T.C. 468

(1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983).

For 1976 and 1977, the petitioner filed no Federal income tax returns. While failure to file is not, in and of itself, conclusive evidence of fraud, such failure may properly be considered in connection with other facts in determining whether an underpayment of tax is due to fraud. Habersham-Bey v. Commissioner, 78 T.C. 304, 312 (1982); Grosshandler v. Commissioner, 75 T.C. at 19. In the present case, the petitioner was a highly educated individual, and as evidenced by his filing of proper Federal income tax returns in prior years, he was fully aware of his obligation to file returns for 1976 and 1977, to report all of his income thereon, and to pay tax on such income. The sham transfers to the church did not mitigate his obligations; by such transfers, the petitioner sought to cloak his activities with tax exemption, but his attempts to conceal his activities reveal his own doubt about the success of his scheme if the facts should come to light.

In 1975, the petitioner retrieved his records from his accountant so that the IRS could not secure information about him from the accountant. In 1976, the petitioner used red checks that could not be copied by the bank and the IRS, until the bank refused to accept such checks. In 1977, the petitioner made a substantial transfer of funds to a Swiss bank. Transfers to a Swiss bank may be made for altogether appropriate business reasons, but it is well known that at times they are made to eliminate any trail of income. In view of the petitioner's other efforts to conceal his business activities, that possible reason for the transfer to the Swiss bank must be considered by us. These activities all show a taxpayer who is familiar with his obligation to report income and pay taxes thereon and who is aware of the techniques that may be used to trace income and is attempting to frustrate the use of such techniques.

The scheme involving the alleged gift of an aircraft to the church was begun in 1975, but it carried over until 1976. Moreover, it reveals the petitioner's attitude toward the payment of taxes. He misrepresented the cost of the aircraft and claimed that it was worth more than the original price paid for it. What is more, he had not paid that price; he had borrowed $18,000, and he repaid that loan out of funds allegedly belonging to the church. There is a question as to whether his church had even been created in 1975, but in any event, it is altogether clear that he claimed a deduction grossly in excess of any to which he was entitled.

On this record, we hold that the petitioner is liable for the additions to tax under section 6653(b) for 1976 and 1977. Because of that holding, we need not consider the Commissioner's alternative claim that the petitioner is liable for the additions to tax under sections 6651(a) for failure to file returns and under section 6653(a) for negligence or intentional disregard of rules and regulations.

Decisions will be entered
for the respondent.

JU 11.7/2: 1986-409

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T. C. Memo. 1986-409

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ORIGINAL

UNITED STATES TAX COURT

RAYMOND M. ENGLISH, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13963-85. Filed September 2, 1986.

Raymond M. English, pro se.

Donna F. Herbert, for the respondent.

MEMORANDUM OPINION

GOLDBERG, Special Trial Judge: This case was heard pursuant to the provisions of section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180, 181, and 182 of the Tax Court Rules of Practice and Procedure.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

6M/VL

Respondent determined a deficiency in petitioner's Federal income tax and additions to tax for the taxable year 1982 as follows:

Income Tax	$4,008.00
Additions to Tax	
Section 6653(a)(1)	200.40
Section 6653(a)(2)	50% of interest due on underpayment of $4,008.00

The issues for our decision are (1) whether petitioner is liable for income taxes on the additional income received during 1982 in the amount of $10,231.00 and (2) whether petitioner is liable for additions to tax under section 6653(a).

Petitioner resided in Seattle, Washington, at the time his petition was filed. Most of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated by reference.

For the taxable year 1982, petitioner filed a Form 1040EZ and reported wage income of $26,590.37 which he received from the Seattle School District. During 1982, petitioner was employed as a teacher in the Seattle public school system; the subject he taught was music. In addition, petitioner also earned the following amounts of income from part-time employment in 1982 which he failed to report on his income tax return.

Source	Amount
Alpine Food Products, Inc.	$ 621.00
Alpine BURTCO Kingdome Co.	9,610.00
Total	$10,231.00

Petitioner does not dispute that he received the additional income from the above stated sources during the year in issue. However, he contends that he did not have to report these amounts because he believes that the additional Federal income tax which would be due on these amounts would be wasted by the Government. His argument is reminiscent of the "war protester" cases; however, he is less articulate and fervent. See, e.g., Scheide v. Commissioner, 65 T.C. 455 (1975); Russell v. Commissioner, 60 T.C. 942 (1973) and the cases cited therein. In these cases, we held that the taxpayers there had no constitutional right to refuse to pay an income tax because the conduct of the United States in Southeast Asia was contrary to their religious convictions or because of their belief that such conduct violated international law.

If petitioner has a quarrel with the manner in which Congress spends citizens' tax dollars which the Treasury collects, he should take the matter up with his congessional representatives. "It is Congress, not petitioner, that has been granted the power to tax and to spend for the general welfare, as well as for other purposes, under article I, section 8, of the Constitution." Russell v. Commissioner, supra at 947.

Petitioner also makes vague references to violations of his Constitutional rights. We need not discuss them since we have addressed them on numerous occasions before. See Rowlee v. Commissioner, 80 T.C. 1111 (1983).

Respondent's determination of the income tax deficiency is presumptively correct and the burden of proof is upon petitioner to show that respondent's determination is incorrect. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Petitioner admitted that he received additional income from the sources shown in the notice of deficiency and has offered no evidence to show that any of the amounts contained therein are incorrect. Accordingly, we sustain respondent's determination.

Respondent also determined that petitioner was liable under section 6653(a) for additions to tax for negligence and intentional disregard of the rules and regulations. This determination will be upheld unless petitioner shows that the underpayment of tax was not due to negligence or intentional disregard of the rules and regulations. McGahen v. Commissioner, 76 T.C. 468, 484 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983). Again, petitioner has not met his burden. His sole argument is that he can validly withhold payment of income taxes when he disagrees with the manner in which the various departments of the Government spend tax dollars. Regardless of the sincerity of petitioner's beliefs, they have no merit.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-410

ORIGINAL

UNITED STATES TAX COURT

JAMES D. STEELE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 32768-85 Filed September 2, 1986.

James D. Steele, pro se.

Roslyn G. Taylor, for the respondent.

MEMORANDUM OPINION

GOLDBERG, Special Trial Judge: This case was heard pursuant to the provisions of section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180, 181, and 182 of the Tax Court Rules of Practice and Procedure.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

G.M. /VL

Respondent determined deficiencies in petitioner's Federal income tax and additions to tax for the taxable years 1978 to 1982, inclusive, as follows:

	1978	1979	1980	1981	1982
Income Tax	$5,030.00	$5,549.00	$6,855.00	$7,461.00	$4,643.00
Additions to Tax					
Section 6651(a)	101.00	576.00	913.75	1,534.25	636.75
Section 6653(a)	251.50	277.45	342.75	--	--
Section 6653(a)(1)	--	--	--	373.05	232.15
Section 6653(a)(2)	--	--	--	*	**
Section 6654(a)	--	61.00	183.00	445.00	199.00

* 50% of interest due on underpayment of $6,137.00

** 50% of interest due on underpayment of $2,547.00

The issues for our decision are (1) whether petitioner is liable for income taxes on the income shown in the notice of deficiency, (2) whether petitioner is liable for additions to tax under sections 6651(a), 6653(a), and 6654(a), and whether we should award damage pursuant to section 6673.

Petitioner resided in Augusta, Georgia, at the time his petition was filed. Most of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated by reference.

For the taxable year 1978, petitioner filed a Form 1040, U.S. Individual Tax Return, which he signed. The only information contained on the form was his name and address. The blocks marked for social security number, occupation, filing status, and exemptions, were marked "object self incrimination"

[sic]. Lines 8, 9, 10C, 11 through 27, 30, 32, 36, 38 through 45, 48 through 53, and 55 through 61 of the Form 1040, were also marked "object self incrimination" [sic]. At the top of the form the following was printed, "I offer to amend or refile this return exactly as you wish it, if you please show me how to do so without waiving my Constitutional rights". By letter dated August 28, 1979, mailed registered mail, return receipt requested, the Director of the Western Region Internal Revenue Service Center informed petitioner that the Form 1040 received from him for the 1978 tax year was not acceptable as an income tax return because it did not supply information required by law, and did not comply with Internal Revenue Code requirements.

For each of the taxable years 1979, 1980, and 1981, petitioner signed and filed a Form 1040, U.S. Individual Income Tax Return, exactly in the same manner as the 1978 Form 1040. For the taxable year 1982, petitioner filed and signed a Form 1040A, U.S. Individual Income Tax Return, exactly in the same manner as in all the previous years at issue, except without the notation printed at the top of the forms for 1978 through 1981. On August 10, 1983, the Director of the Western Region, Internal Revenue Service Center, mailed another registered letter to petitioner informing him that the Form 1040A received from him for the 1982 tax year did not contain information required by law and that it did not comply with certain Internal Revenue Code requirements.

In his notice of deficiency, respondent determined that petitioner failed to report wages which petitioner received for tax years 1978 through 1982 in the amounts and from the sources listed below:

Year	Employer	Amount
1978	Howard P. Foley Co.	$2,565.00
	Tennessee Valley Authority	8,940.00
	Fischbach and Moore, Inc.	1,306.00
	Watson-Flagg Electric Co., Inc.	4,112.00
	Bechtel Power Corp.	5,971.00
	Total	$22,894.00
1979	Code Electric Corp.	$10,559.00
	Bechtel Power Corp.	14,407.00
	Total	$24,966.00
1980	Code Electric Corp.	$28,059.00
	Bechtel Power Corp.	257.00
	Total	$28,316.00
1981	Code Electric Corp.	$ 785.00
	Bechtel Power Corp.	15,731.00
	Dynalectric Co. of New York	13,578.00
		$30,094.00
1982	Bechtel Power Corp.	$ 7,982.00
	Dynalectric Co. of Nevada	4,773.00
	Nevada Employment Security Department	3,808.00
	Simmons Electric Corp.	1,438.00
	Jensen Electric, Inc.	5,886.00
	Total	$23,887.00

Petitioner does not dispute that he received income from the above listed sources during the years in issue. However, he contends that (1) he is denied due process of law by not being afforded a right to a jury trial guaranteed by the Seventh Amendment to the Constitution and (2) he will be forced to waive his right against self-incrimination provided by the Fifth Amendment to the Constitution if he is required to supply information requested on Forms 1040 and 1040A and to testify at trial.

At the trial of this case, counsel for respondent stated that there is no pending criminal prosecution against petitioner, nor is one contemplated.

Petitioner bases his objections to complying with the Internal Revenue laws upon long rejected arguments frequently asserted by tax protesters. We will now address them.

Petitioner has not been wrongfully denied a jury trial. The Seventh Amendment does not apply to suits against the United States, because there was no common law action against the sovereign. McElrath v. United States, 102 U.S. 426, 440 (1880). Thus, it has repeatedly been held that there is no constitutional right to a jury trial in the Tax Court. Phillips v. Commissioner, 283 U.S. 589, 599 n. 9 (1931); McCoy v. Commissioner, 696 F.2d 1234 (9th Cir. 1983), affg. 76 T.C. 1027 (1981); Lonsdale v. Commissioner, 661 F.2d 71, 72 (5th Cir. 1981), affg. a Memorandum Opinion of this Court; Dorl v. Commissioner, 507 F.2d 406 (2d Cir. 1974), affg. 57 T.C. 720 (1972); Rowlee v. Commissioner, 80 T.C. 1111, 1115 (1983).

To invoke the Fifth Amendment privilege, petitioner must be faced with substantial hazards of self-incrimination that are real and appreciable, and must have reasonable cause to apprehend such danger. Edwards v. Commissioner, 680 F.2d 1268, 1270 (9th

Cir. 1982), affg. per curiam an unreported decision of this Court; United States v. Neff, 615 F.2d 1235, 1239 (9th Cir. 1980), cert. denied 447 U.S. 925 (1980). A tax return form which contains no information from which income tax liability can be calculated but merely has assertions of the privilege against self-incrimination does not constitute a tax return within the meaning of the Internal Revenue laws. United States v. Neff, supra at 1238. In order for a document to constitute a tax return of a taxpayer, four criteria must be satisfied. First, it must contain sufficient data from which respondent can compute and assess the taxpayer's liability; second, it must purport to be a return; third, it must represent an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury. Beard v. Commissioner, 82 T.C. 766, 777 (1984), affd. per curiam 793 F.2d 139 (6th Cir. 1986). Clearly, the Forms 1040 and 1040A filed by petitioner were not income tax returns under the statute. The requirement that citizens file a yearly income tax return does not, of itself, violate their privilege against self-incrimination. This conclusion is implicit from the Supreme Court holding in United States v. Sullivan, 274 U.S. 259 (1927), that the privilege does not justify an outright refusal to file any tax return at all. United States v. Neff, supra at 1235.

We find that there were no substantial hazards of self-incrimination that were real and appreciable and that confronted petitioner at the time he filed his Forms 1040 and 1040A, or when this case was called for trial. Therefore, he cannot hide behind the privilege against self-incrimination in his refusal to testify or file Forms 1040 and 1040A that comply with Internal Revenue Code requirements.

Respondent's determination of the income tax deficiencies is presumptively correct and the burden of proof is upon petitioner to show that respondent's determination is incorrect. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner's Fifth Amendment privilege against self-incrimination does not relieve petitioner of his burden of proof under our Rule 142(a), particularly where, as here, we have concluded that his Fifth Amendment claim is without merit. Wilkinson v. Commissioner, 71 T.C. 633, 637-638 (1979); see Roberts v. Commissioner, 62 T.C. 834 (1974). See also Rockwell v. Commissioner, 512 F.2d 882 (9th Cir. 1975), cert. denied 423 U.S. 1015 (1975).

Petitioner admitted that he received income from all of the sources shown in the notice of deficiency and has offered no evidence to show that any of the amounts contained therein are incorrect. Accordingly, we sustain respondent's determination.

Respondent also determined that petitioner was liable for additions to tax under section 6651(a)(1) for failure to file income tax returns. Petitioner has stipulated and we have found that the Forms 1040 filed for tax years 1978 through 1981, and the Form 1040A filed for tax year 1982, were not income tax returns as contemplated under the Internal Revenue Code. Petitioner was required to file returns for all years at issue. See sec. 6012; sec. 1.6012-1, Income Tax Regs. Further, petitioner presented no evidence excusing himself from those requirements other than his Fifth Amendment argument which we have found to be without merit. Accordingly, we find that he is liable for the additions to tax under section 6651(a). Thompson v. Commissioner, 78 T.C. 558, 562-563 (1982).

Respondent also determined that petitioner was liable under section 6653(a) for additions to tax for negligence and intentional disregard of the rules and regulations. This determination will be upheld unless petitioner shows that the underpayments of tax were not due to negligence or intentional disregard of the rules and regulations. McGahen v. Commissioner, 76 T.C. 468, 484 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983). Again, petitioner's sole argument is that he is protected by the Fifth Amendment, which we reject. Consequently, we find for respondent on this issue.

Finally, we must decide whether to award damages to the United States under section 6673. This Court may award damages of up to $5,000 whenever the taxpayer institutes or maintains proceedings before us primarily for delay or the taxpayer asserts a frivolous or groundless position in such proceedings. We find that petitioner's contentions are frivolous and groundless in light of the cases cited above (and numerous others considering these same arguments), and in light of our admonition to him during a pretrial conference where we explained why his arguments lacked merit. We are satisfied that petitioner has instituted this proceeding primarily for delay. Abrams v. Commissioner, 82 T.C. 403 (1984); Sydnes v. Commissioner, 74 T.C. 864, 870-873 (1980), affd. 647 F.2d 813 (8th Cir. 1981). Accordingly, we award $5,000 of damages to the United States.

Decision will be entered
for the respondent.

JU11.7/2: 1986-411

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T. C. Memo. 1986-411

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UNITED STATES TAX COURT

GUNTER W. HEIDIG AND JANIS HEIDIG, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 32072-85. Filed September 3, 1986.

Gunter W. Heidig, pro se.

Wilton A. Baker, for the respondent.

MEMORANDUM OPINION

NAMEROFF, Special Trial Judge: This case was heard pursuant to the provisions of section 7456 and Rule 180.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect for the year at issue, unless otherwise stated. All Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

C. M/VL

In this case respondent determined deficiencies and additions to tax as follows:

Tax Year	Deficiency in Income Tax	Additions to Tax Sec. 6651(a)(1)	Additions to Tax Sec. 6653(a)(1)
1980	$387.00	$100.00	$19.00
1981	$432.00	$100.00	$22.00
1982	$251.33	$ 62.83	$12.57

Respondent also determined additions to tax under section 6653(a)(2) for 1981 and 1982, computations of which are based upon the entire amount of each deficiency.

Identical, but separate, determinations of deficiencies and additions to the tax were made against each petitioner for the years 1980 and 1981. The determinations with regard to Mr. and Mrs. Heidig for the years 1980 and 1981 are not based upon a joint return or joint and several liability, but, as respondent explained at the trial, are alternative positions; that is, a finding of liability for one petitioner with respect to either of these years relieves the other petitioner for any liability for such year. The determination for 1982 is with respect to Mr. Heidig only.

The issues for our decision are: (1) whether either petitioner is liable for self-employment tax for each of the years 1980 and 1981, and, if so, in what amount; (2) whether either petitioner is liable for additions to tax for 1980 and 1981 as set forth above; (3) whether petitioner husband is liable for self-employment tax and additions to tax for 1982; and (4) whether this Court should impose damages under section 6673 pursuant to respondent's motion filed with the Court at the call of the calendar.

Some of the facts were orally stipulated at the commencement of the trial of this case. On or about February 14, 1983, purported joint individual income tax returns forms 1040 were received by the Internal Revenue Service from Gunter W. and Janis Heidig for the taxable years 1980 and 1981. Each of these documents was signed by petitioners and also by a preparer, but the words "under penalties of perjury" by the signature section were deleted from each of the documents. As a result of such alterations, the Internal Revenue Service did not treat the documents as filed returns.[2]

Subsequently, a revenue agent commenced an audit with regard to petitioners' income tax liabilities for 1980 and 1981. The altered 1040's reflected no taxable income, but did report self-employment tax of $320 for 1980 and $540 for 1981. At some point in the course of the revenue agent's examination, he prepared new returns for petitioners' signature, reflecting self-employment taxes of $325 and $382, which petitioners refused to sign.

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[2] Indeed, respondent treated the documents as frivolous returns and assessed penalties under section 6702. While petitioners have complained about this action in various documents filed with this Court and during trial, it is clear that this Court has no jurisdiction to consider the matter. Section 6703(c)(2). In addition, see Hewlett v. United States, an unreported case (S.D. Ohio 1984, 54 AFTR 2d 84-5546, 84-2 U.S.T.C. par. 9664); Johnson v. Internal Revenue Service, an unreported case (N.D. Cal. 1984, 54 AFTR 2d 84-6028, 84-2 U.S.T.C. par. 9812).

Nevertheless, as indicated above, respondent issued notices of deficiency for 1980 and 1981 asserting deficiencies of $387 and $432, respectively, which amounts consist solely of self-employment tax under section 1401.

Petitioner Gunter Heidig testified that the business which gave rise to the asserted self-employment tax for each of the years 1980 and 1981 was called Right-Way and involved the sale of vitamins. He further testified that it was owned and operated by his wife Janis Heidig and that he didn't know too much about it. Gunter Heidig was involved, in those years, in other endeavors. Respondent offered no contrary evidence nor any reason to disbelieve petitioner on this point.[3]

Petitioners were residents of Nevada during the years at issue and at the time of the filing of the petition herein. Nevada is a community property state. Accordingly each of the petitioners is regarded as having earned one-half of the total income of the community. However, section 1402(a)(5) in defining the term "Net earnings from self-employment," provides that

> (5) if
> (A) any of the income derived from a trade or business (other than a trade or business carried on as a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in

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[3] We note that the Schedules C on the altered returns reflect a business and both petitioners are listed in the block requesting "name of proprietor."

> which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; * * *

"Management and control" means actual management and control rather than imputed from husband to wife under community property laws. Section 1.1402(a)-8, Income Tax Regs. In other words, only the spouse carrying on the business activities will be subject to taxes imposed under section 1401 and the tax will be computed on the total gross income less the total business deductions, notwithstanding the attribution of one-half to the other spouse for income tax purposes. Accordingly, we find that all of the self-employment tax liability for 1980 and 1981 is attributable to activities of Janis Heidig.

With respect to the proper amount of self-employment tax, the petitioner has the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Based on the record before us, we hold that petitioner Janis Heidig has failed to satisfy her burden that respondent's determination is erroneous. Petitioner Gunter Heidig alluded to some error in the computation of the net profits from the business, but was unable to describe that error with any degree of exactitude. Moreover, we regard the altered forms 1040 acknowledging liability for $320 and $540 for 1980 and 1981 respectively, as contrary admissions against interest, casting doubt on such testimony. With regard to the significance of the revenue agent's computations prepared during the audit, it is well settled that matters arising during the course of the audit would not be admissible against the Commissioner as an attempt to look behind the notice of deficiency. Our determination must be based on the merits of the case and not on any previous record developed at the administrative level. Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324 (1974). We therefore sustain respondent as to the deficiencies due from Janis Heidig and accordingly hold for petitioner Gunter Heidig with regard to 1980 and 1981.

Having found that Gunter Heidig is not liable for any deficiencies for 1980 and 1981, it follows that he is not liable for any additions to tax for those years.

Turning to Janis Heidig's liability for additions to tax for 1980 and 1981 for negligence or intentional disregard of rules and regulations, petitioners allege religious convictions against taking any secular oaths for refusing to sign the returns under penalties of perjury. Section 6065, requires a verification under penalties of perjury.[4] It is significant that section 6065 requires a "declaration", rather than an "oath". Indeed, the tax return which petitioner altered provides: "Under penalties of perjury, I declare that I have examined the return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." (Emphasis added.) Petitioners have ignored the rules and regulations. Hence, respondent's determinations regarding sections 6653(a)(1) and 6653(a)(2) are sustained.

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[4] Section 6065 specifically requires that "any return * * * be verified by a written declaration that it is made under the penalties of perjury." By altering the declarations on the 1980 and 1981 forms 1040, petitioner failed to verify their returns under the penalties of perjury. Therefore those forms do not constitute returns as required by law. Cupp v. Commissioner, 65 T.C. 68, 78-79 (1975) affd. without published opinion 559 F.2d 1207 (3d Cir. 1977); Ellison v. Commissioner, T.C. Memo. 1976-282, affd. per order (10th Cir., Jan. 20, 1978).

No evidence was submitted as to any reasons for the failure to timely file returns (or the delinquent submission of the purported returns). Therefore, the additions to the tax under section 6651(a) are also sustained, except as modified below.

The respondent determined additions to tax for delinquency for each of the years 1980 and 1981 of $100. For those years the maximum amount of addition to tax under section 6651(a)(1) is 25 percent of the amount required to be shown as tax on the return. Twenty-five percent of $387 is $96.75, whereas 25 percent of $432 is $108. For the year 1981, not having made a claim under section 6214 for an increased deficiency in addition to tax respondent is limited to his determination of $100. On the other hand, the maximum addition to tax for 1980 is $96.75.

We note that section 6651(a) was amended in 1982 to add the following language:

> In the case of a failure to file a return imposed by chapter 1 within 60 days of the date prescribed for filing of such return (determined without regard to any extensions of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, the addition to tax

> under paragraph (1) shall not be less than the lesser of $100 or 100 percent of the amount required to be shown as tax on such return.

That amendment to section 6651(a) was added by the 1982 Tax Equity and Fiscal Responsibility Act (Pub. L. 97-248, section 318(a) 96 Stat. 610), and the effective date of the amendment is for returns the due date for filing of which (including extensions) is after December 31, 1982. Section 318(c). Thus, the amendment does not apply to 1980 and 1981 returns.[5] Accordingly, we hold that petitioner Janis Heidig is liable for additions to tax under section 6651(a) for 1980 in the amount of $96.75, and for 1981 in the amount of $100.00.

With regard to the determinations by respondent for 1982, the tax again involves solely the assertion of self-employment tax of $251.33, plus additions to tax as set forth above. No evidence was submitted to substantiate any claim of error on the part of respondent. Based upon the record, we hold that petitioner has not satisfied his burden of proof and sustain respondent's determination in its entirety for 1982.

Finally, respondent has filed a motion to impose damages against petitioners under section 6673. Prior to the trial of this case, petitioners submitted a document purporting to convince the Court that Nevada, the state of their residence during the years at issue and at the time of the filing of the petition herein, was not properly part of the United States;

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[5] But the statute does apply to the 1982 return, with respect to which respondent determined an addition to tax for delinquency of $62.83.

allegedly, with the exception of the original 13 colonies, most of the North American continent is still part of Spain and therefore the United States has no jurisdiction over that territory or over residents thereof. Subsequently, petitioners submitted documents urging the Court to rule that the Sixteenth Amendment was not properly ratified and that the income tax laws are unconstitutional. We need not dwell on the lack of merit for these frivolous arguments.

Nevertheless, petitioners did attempt to litigate the merits of the determinations and have partially succeeded. Accordingly we deny respondent's motion for damages. We wish to note, however, for petitioners' benefit that any subsequent attempt to convince the Court of merit to these utterly frivolous arguments will be dealt with accordingly.

An appropriate decision will be entered.

JU 11.7/2:1986-412

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T. C. Memo. 1986-412

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UNITED STATES TAX COURT

LINDA NEU-KRAEMER, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 40388-84. Filed September 3, 1986.

Patience D. Roggensack, for the petitioner.

James M. Klein, for the respondent.

MEMORANDUM OPINION

PANUTHOS, Special Trial Judge: This case was heard pursuant to the provisions of section 7456(d) of the Internal Revenue Code of 1954 and Rules 180, 181 and 182 of the Tax Court Rules of Practice and Procedure.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as applicable to the years in question, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

C. M. /VL

In his notice of deficiency, dated September 13, 1984, respondent determined deficiencies in petitioner's Federal income taxes for the taxable years 1980 and 1981 in the amounts of $4,562 and $3,420, respectively.[2]

The sole issue for decision is whether the payments received by petitioner, Linda Neu-Kraemer, from her former husband, David Kraemer, pursuant to their decree of divorce, are to be characterized for tax purposes as alimony or child support.

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner resided in Madison, Wisconsin at the time she filed her petition in this case.

Respondent issued separate Statutory Notices of Deficiency to both petitioner, Linda Neu-Kraemer, and her former husband, David R. Kraemer, (hereinafter Linda and David) determining deficiencies in the Federal income taxes of each party for the years 1980 and 1981. The deficiencies determined against each party were based on respondent's adopting an inconsistent position regarding the nature of the payments made by David to petitioner, Linda, pursuant to their divorce decree of December 18, 1979.

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[2] The parties have stipulated that the payments received by petitioner from her former husband in 1980 amounted to $15,600 rather than $16,400 as set forth in the Notice of Deficiency. Accordingly, there is no dispute as to the amount of payments made, only the characterization of the payments.

Each party individually filed a petition with this Court for resolution of their respective disputes.[3] David and Linda were married on April 8, 1967. There were two children born of this marriage; Thomas David and Kerin Angela, both of whom were minors during the years involved. David and Linda were divorced on December 18, 1979.

Pursuant to their divorce, David and Linda, both represented throughout by their respective attorneys, negotiated a division of their marital property, which was incorporated into their divorce judgment by written stipulation. Sections three and four of the Stipulation set forth the parties' agreement concerning the support payments to be made by David to petitioner. The sections provide as follows:

> 3. FAMILY SUPPORT.
>
> A. The Joint Petitioner, David R. Kraemer, shall pay the sum of One Thousand Two Hundred Dollars ($1,200.00) per month to the Joint Petitioner, Linda Neu-Kraemer as and for family support for the support and maintenance of the family commencing the 10th day of the month subsequent to the final hearing in this matter. Said payments shall be made monthly, so long and until Thomas D. Kraemer obtains 18 years of age, and $600.00 monthly so long as and until Kerin A. Kraemer attains 18 years of age.

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[3] These cases were consolidated for purposes of trial by motion of respondent on November 25, 1985. Subsequently, David moved this Court to sever his case from petitioner's docket, and stipulated to be bound by the final decision reached in the present case. The Motion to Sever and Stipulation were filed with this Court on January 6, 1986 in docket number 41077-84, David R. Kraemer, Petitioner, v. Commissioner of Internal Revenue, Respondent. The Motion to Sever was granted by order dated January 6, 1986.

> B. The maintenance hereunder shall be increased or decreased by governmental national cost of living increases or decreases commencing January 1, 1981 using January 1980 as a base point. Similar changes shall be made annually thereafter during the time that maintenance is required hereunder, all predicated on the year 1980 as a base point.
>
> 4. MAINTENANCE: LIMITED TIME.[4]
>
> A. David R. Kraemer shall pay the sum of Eight Hundred Dollars ($800.00) per month to Linda Neu-Kraemer as and for maintenance payments which shall terminate upon her remarriage, death or upon the passage of 36 monthly payments, whichever occurs first. The maintenance shall not be subject to revision by the court. Said payments shall commence on the 10th day of the first month following entry of judgment herein and shall continue up to and including the 10th day of January, 1983.
>
> B. It is the intention of the parties that these maintenance payments shall be deductible for income tax purposes to the Joint Petitioner, David R. Kraemer and taxable as income to the Joint Petitioner, Linda Neu-Kraemer, under applicable state and federal law. This agreement shall be construed in accordance with such intent.

On a Form 1040X for the year 1980 and on her 1981 return, petitioner treated the payments she received pursuant to Section Three of the Stipulation as child support and, accordingly, she did not include these amounts as income.

Respondent determined that the payments are alimony, as defined in section 71(a) of the Internal Revenue Code of 1954, and as such are taxable to petitioner as gross income.

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[4] We note there is no dispute that the section four payments are alimony income to petitioner.

Petitioner asserts that these payments are child support, as set forth in section 71(b) and as such are not includable in her gross income for the years in question.

Section 71(a)[5] requires a taxpayer to include in gross income periodic payments received under a divorce decree in discharge of a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by the former spouse under the decree. Section 71(b) provides that subsection (a) shall not apply to that part of any payment which "the terms of the decree * * * fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband." Where the periodic payments are received by the taxpayer for the support and maintenance of himself or herself and the minor children, the provisions of section 71(b) do not apply unless the decree fixes, by specific designation, the amount or percentage of such payments which are for the support of the minor children. If the portion which is for the support of the minor children is not so fixed, the full amount is includable in the recipient taxpayer's income. Section 1.71-1(e), Income Tax Regs.; Commissioner v. Lester, 366 U.S. 299 (1961).

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[5] Section 71 was amended after the years in issue. All references to section 71 relate to that section as applicable to the years in issue.

Petitioner argues that the payments she received pursuant to Section Three of the divorce decree do not constitute alimony because they were not made by David in discharge of a legal obligation within the meaning of section 71(a). Additionally and in the alternative, petitioner argues that the payments were fixed by the divorce decree in compliance with section 71(b).

Although the characterization of a payment under State law does not generally control the Federal tax consequences, we have held that State law is determinative of the existence of a "legal obligation" for purposes of section 71(a). Hoffman v. Commissioner, 54 T.C. 1607, 1611 (1970), affd. per curiam 455 F.2d 161 (7th Cir. 1972); Brown v. Commissioner, 50 T.C. 865 (1968), affd. per curiam 415 F.2d 310 (4th Cir. 1969).

Petitioner and her former husband entered into a written stipulation in preparation for their divorce, which set forth their agreement as to the division of their marital property and the monthly payments to be made. This stipulation was adopted by the Wisconsin Circuit Court for Dane County in the decree of divorce. The stipulation thus became merged into the decree, and subsequent thereto, the rights and obligations of the parties were dependent upon the Wisconsin Circuit Court decree.[6]

Petitioner undoubtedly relied upon the legality of the decree, and the ability of the Circuit Court of Wisconsin to render and enforce the judgment. Further, there is no dispute as to the Circuit Court's ability to proceed as such under Wisconsin law.[7] We find that a legally binding decree of divorce existed between the parties.

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[6] Hoffman v. Commissioner, 54 T.C. 1607, 1613 (1970), affd. per curiam 455 F.2d 161 (7th Cir. 1972).

We now look to determine whether, if at any time subsequent to the entering of the judgment, a situation occurred which altered or terminated David's legal obligation to make the monthly payments to petitioner under Wisconsin law. Petitioner relies on Hoffman v. Commissioner, supra as support for the argument that David's legal obligation under section 71(a) did not exist.

Petitioner's reliance on Hoffman is misdirected. In Hoffman, the former husband continued to make the monthly payments to his former wife and deduct them as alimony after his former wife had remarried. Under the laws of the State of Illinois,[8] a party is not entitled to alimony upon remarriage. In Hoffman, the Court held that Illinois law was determinative of the existence of the former husband's "legal obligation" to make alimony payments. Since there could no longer be a legal obligation for the former husband to make alimony payments to his remarried former spouse, the payments were not alimony for the purposes of section 71(a). In the case before us, there is no evidence of a remarriage or other change of circumstance, which under Wisconsin law, modifies or terminates David's legal obligation to make the monthly payments pursuant to the divorce decree.

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[7] See Wis. Stat. Ann. secs. 767.10, 767.25, and 767.26 (West 1981).

[8] Ill. Rev. Stat. ch. 40, sec. 19 (1956).

Having determined that the monthly payments were made by David in discharge of a legal obligation within the meaning of section 71(a) of the Code, we now must determine the characterization of the payments for tax purposes. Petitioner argues that the payments made pursuant to Section Three of the divorce decree were fixed by the agreement as child support in accordance with section 71(b). As we have previously indicated, this matter is governed by Commissioner v. Lester, supra. See also Brock v. Commissioner, 566 F.2d 947 (5th Cir. 1978); Abramo v. Commissioner, 78 T.C. 154 (1982).

We find the decree does not specifically fix the amount of the payments which are to be child support. The provision of the decree entitled "Family Support" states that the amount shall be paid to Linda Neu-Kraemer "as and for family support for the support and maintenance of the family." The language does not expressly state a sum certain or percentage as child support. Section 71(b) is clearly worded. The written instrument itself must fix the portion of the payments that is child support.[9] The fact that the parties might have intended a different result does not satisfy the provision.

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[9] Commissioner v. Lester, 366 U.S. 299, 303 (1961); Sperling v. Commissioner, T.C. Memo. 1982-681, affd. 726 F.2d 948 (2d Cir. 1984).

Petitioner argues that if the agreement is considered in its entirety, one would conclude that the payments are child support rather than alimony. For example, petitioner contends that Section Eight of the agreement, relating to life insurance, when considered together with Section Three of the agreement, would lead to the conclusion that the payments are child support. This argument is of no assistance to petitioner. The decree does not meet the clear standards required by section 71.

Due to respondent's concession as to the amount actually received by petitioner,

Decision will be entered
under Rule 155.

JV 11.7/2:1986-413

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T. C. Memo. 1986-413

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UNITED STATES TAX COURT

JOSEPH K. McENEANY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3010-84.　　Filed September 3, 1986.

Duane D. Conover, for the petitioner.

Michael Phalin and James Kamman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

BUCKLEY, Special Trial Judge: The proceedings in this case were conducted pursuant to section 7456(d)(3) of the Code,[1] and Rules 180, 181 and 182, Tax Court Rules of Practice and Procedure.[2]

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

[2] This case was originally filed as a small tax case as provided for in section 7463. On November 1, 1984, counsel for (footnote continued)

G.M./VL

In a statutory notice of deficiency dated November 10, 1983, respondent determined a deficiency in petitioner's 1982 Federal income tax of $2,255. The sole issue for decision is whether petitioner, who is under vows of poverty and obedience to an Order of Roman Catholic priests, may exclude from gross income amounts received from the State of California as compensation for his services as the Catholic Chaplain at a State hospital for the mentally disabled.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits thereto are incorporated herein by this reference.

At the time he filed his petition in this case, as well as all other times relevant to this litigation, petitioner resided in Costa Mesa, California. Petitioner filed his 1982 Federal income tax return with the Internal Revenue Service Center at Fresno, California. Petitioner was issued a W-2 Wage and Tax Statement for the 1982 tax year showing "wages, tips, other compensation" of $27,336. His timely filed Federal income tax return for 1982 showed "wages, salaries, tips, etc.," of $0.00 and referred to an attached statement contending that all monies earned by him were not taxable to him because they were earned as an agent of a religious order. In arriving at the deficiency

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(footnote continued from previous page)
both parties moved the Court to remove this case from the small case category and by order the Court granted the joint motion.

determination respondent allowed petitioner a charitable contributions deduction equal to 50 percent of his adjusted gross income. See sec. 170(b)(1).

Petitioner was ordained a Roman Catholic priest in 1958. He is a member of the Congregation of the Sacred Hearts of Jesus and Mary (herein Order) of the Roman Catholic Church. He has been a member of the Order at all times relevant hereto. The Order is an organization exempt from tax under section 501(c)(3). As a member of the Order, petitioner is under vows of poverty and obedience. His vow of poverty dictates that any money earned by him or any other accession to wealth received by him is to be turned over to the Order. Because of his vow of obedience, petitioner must take any assignments and perform any duties given to him by his superiors in the Order.

Fairview State Hospital (herein Fairview) is a hospital for the mentally disabled located in Costa Mesa, California, and operated by the California Department of Developmental Services. Fairview provides Catholic, Jewish and Protestant chaplains to minister to the spiritual needs of patients at the hospital. The patients (now popularly referred to as clients) at Fairview are developmentally disabled persons.

In 1960, Fairview was in need of a priest to fill the Catholic chaplain position. Fairview requested the Roman Catholic Archdiocese of Los Angeles (herein Archdiocese) to provide a priest to fill the position and to minister to the spiritual needs of the patients. The Archdiocese, in turn, requested petitioner's Order to provide the Catholic Chaplain needed at Fairview and Father McEneany was appointed to that position by the then provincial superior[3] of the Order.

At the time the vacancy arose, petitioner had been assigned by his Order to go to Ireland to start a minor seminary. Two days before he was set to sail, he was informed by Rev. William J. Condin, ss.cc., who was the provincial superior of his Order at that time, that instead of going to Ireland, he was to report to Fairview and serve as the Catholic Chaplain. Petitioner, in accordance with his vow of obedience, went to Fairview as directed.

Fairview State Hospital is a California state facility and all employees are subject to the employment process of the State civil service system which necessitates that payroll checks be issued directly to the person performing the services of the position. Direct payment by the State to the Catholic church, the Archdiocese or to the Order is not possible since the State is prohibited from contracting for services which can be provided through the civil service system. There is a civil service classification of Catholic Chaplain.

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[3] The provincial superior of the Order is the head of an ecclesiastical province; the presiding member of a religious order in a province. The Random House College Dictionary 1065 (rev. ed. 1982).

Fairview appointed petitioner Catholic Chaplain on October 1, 1960. In connection with this appointment he filed an application detailing his educational and work history, as well as a supplementary letter outlining more fully his clinical pastoral training. His appointment was approved by the State personnel board on November 1, 1960. Petitioner has remained the Catholic chaplain at Fairview up until the date of trial.

Petitioner's compensation is set by the State. As a civil service appointee, he is a compulsory participant in the State Public Employee Retirement System.[4] He is also a compulsory member of Fairview's employee bargaining unit.

Petitioner, under his vow of poverty, has consistently negotiated his paychecks, which are received monthly, to the Order. Upon receipt of each paycheck, petitioner writes on the back of the check, "for deposit only to the Sacred Hearts Fathers." He then forwards the checks to the Order's treasurer.

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[4] Petitioner did testify that upon his retirement from Fairview, his vow of poverty would require that he turn over any State retirement benefits to the Order.

At the same time, he notifies the Order of how much money he needs to meet his living expenses.[5] The Order's treasurer then supplies the needed money.

Through a letter stipulated to by both parties, Louis H. Britt, Personnel Officer at Fairview, in commenting on the manner in which petitioner handles his paychecks, states that, "[d]ue to his vow of poverty [petitioner], is not allowed the use of his payroll warrants. This has the effect of reimbursing the Church through his religious order (Sacred Hearts) for his duties."

Petitioner's duties and responsibilities at Fairview are solely the performance of the priestly duties of a Catholic chaplain. He has no secular duties whatsoever. Thus, he says mass every Sunday, as well as on other occasions. He hears confessions, gives communion, performs baptisms, assists at confirmations, and anoints the sick. He gives religious counsel to Fairview staff members, to families of patients and to those patients able to comprehend such counsel. When petitioner first came to Fairview in 1960, many patients were in the 60-80 IQ range and he was able to do much spiritual work with them. In later years, the nature of the patients changed so that most are severely retarded and require constant help and care. Many now are severely retarded and in need of constant care. Some are so ill that they are incapable of recognizing their own parents. He works with a Catholic lodge, the Knights of Columbus, many of whom volunteer at the hospital where they assist in wheeling patients to mass.

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[5] Regarding these expenses, petitioner testified as follows, "I need money for my car and other things, and my food, and then [the treasurer] sends the money back to me, whatever I need, whether it's $300 a month, or $400 sometimes a month."

Petitioner testified that from 1960 to 1977 he lived on the hospital grounds. In 1977, the house in which he was living was needed for hospital use and petitioner was forced to make different living arrangements. With the permission of the Order, petitioner took up residence in a "private house about three or four minutes from the hospital."

There is no one in the State or the Fairview administration who supervises petitioner in his duties. He does report his presence when he is physically within the hospital so that the administration will know where he is, but other than that he is not supervised in his role as chaplain. In this regard, petitioner testified: "They say, 'well, we can't tell you how to say mass, and how to give the sacraments, so we leave that all up to you.'" His functions at Fairview are all sacerdotal in nature.

The only supervision or control of petitioner's activities lie in the hands of his religious hierarchy. Thus, the superior of his Order may reassign him at will. Further, the Bishop of Orange County, the Diocese in which Fairview is located, grants him his faculties, viz, his right to function as a priest within the diocese. Fairview provides petitioner with an office which he uses for counseling, for patients and their parents wanting to confer with him, and for confession. He maintains his religious records of Baptism, Holy Communion and Confirmation in the office.

ULTIMATE FINDING OF FACT

Petitioner was not at Fairview as an agent of the Order, and salary paid to him by the State was compensation to him for his services and includable in his gross income.

OPINION

Once again we consider the issue whether a petitioner's wages were paid to him in his individual capacity or as an agent for his Order. Section 61 defines gross income as "income from whatever source derived," and subsection (a)(1) specifically includes compensation for services within this definition. Moreover, it is a fundamental principle of Federal income tax law that income is taxed to the person who earns it and any attempt by a taxpayer to shift the incidence of taxation, by anticipatorily assigning income earned in his individual capacity, will be ineffectual. Lucas v. Earl, 281 U.S. 111 (1930). The fact that income is taxed to the person who earned it has come to be known as the first principle of Federal income taxation. Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949). It is, however, not always apparent as to who has earned a particular item of income. This case presents such an instance. Ten years before Lucas v. Earl, supra, was decided the Supreme Court held that income earned by an agent on behalf of a separate and distinct principal is the income of the principal and not the agent--provided that the agent, in accordance with his or her fiduciary duty, assigns or turns the income over to the principal. Maryland Casualty Co. v. United States, 251 U.S. 342 (1920).

In order to resolve the dispute now before us, we must determine whether the payments received by petitioner from the State of California, because of his services as the Catholic Chaplain at Fairview, were earned by him individually or as an agent of the Order. Should we determine that the payments were earned by petitioner in his individual capacity, they are income to him. The subsequent transfer of those payments will not relieve petitioner of Federal income tax liability, as the transfer would be nothing more than an assignment of income. Lucas v. Earl, supra. If on the other hand we determine that the payments were received by petitioner in his capacity as an agent of the Order, they would not be taxable income to him, but rather to the Order.[6] Cf. McGahen v. Commissioner, 76 T.C. 468, 478-479 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983).

It is clear that in 1982 petitioner received payments totaling $27,336 from the State of California. Our only concern here is the capacity in which petitioner received those payments--whether as an individual or as an agent of the Order. We must determine who is the proper taxpayer, and the "choice of the proper taxpayer revolves around the question of which person or entity * * * controls the earning of the income." Vnuk v. Commissioner, 621 F.2d 1318, 1320 (8th Cir. 1980), affg. a Memorandum Opinion of this Court; Johnson v. United States, 698 F.2d 372, 374 (9th Cir. 1982); Vercio v. Commissioner, 73 T.C. 1246 (1980).

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[6] Since the Order is an organization exempt from tax, the income would escape all Federal income tax if we determine that petitioner received it as the Order's agent.

We have recently held that a Catholic nun, who worked as a nurse-midwife for an agency of the Federal Government that assigns health care professionals to work in areas lacking adequate health care facilities, must pay Federal income taxes on compensation received for her services despite the fact that she faithfully turned over her paychecks to her Order pursuant to a vow of poverty. Schuster v. Commissioner, 84 T.C. 764 (1985), appeal pending (7th Cir., July 23, 1985). The facts in Schuster, although not identical, are similar to the facts presented here and because of this a similar analysis must be undertaken.

As in Schuster, supra at 773:

> The instant case is unlike many of the so-called "vow of poverty" cases decided recently by this Court in that [petitioner] at all times acted strictly in accordance with [his] vows of poverty and obedience, and at no time after endorsing the checks did [he] exercise any sort of control over the funds. Petitioner is part of a long tradition that is respected in our society, and these private arrangements with [his] Order arise from deeply held convictions. The fact that we feel [his] life is a sincere and worthwhile example should not, however, alter the tax results. In the final analysis, apart from petitioner's vow of poverty arising from [his] personal religious

> convictions and way of life, this case is not different from any other assignment of income case. [Fn. ref. omitted.]

In determining whether petitioner received the payments from the State of California in his individual capacity or as an agent of the Order, we must look beyond the private agreements between petitioner and the Order. Instead, we must inquire into whether petitioner performed his services as an employee of the State of California or whether the State contracted to receive the services from the Order, with petitioner performing the service on behalf of the Order, as its agent. See Schuster v. Commissioner, supra at 775. Therefore, we are required to determine whether the Order is under a legal duty or obligation to provide the services performed by petitioner, or to ensure that they be performed. In the absence of any legal obligation, the Order is nothing more than an "irrelevant bystander" and the petitioner cannot be acting on behalf of or as the agent of the Order. Schuster v. Commissioner, supra at 774.

As we stated in Schuster v. Commissioner, supra at 774-775:

> This analysis implicitly underlies the Supreme Court's decision in Maryland Casualty Co. v. United States, supra. In that case, the agent did not escape taxation because he was obliged to transmit the funds to his principal, nor did he escape taxation because his principal approved of his conduct. Rather, the Supreme Court reached its conclusion because "payment of the premium to the agent discharged the obligation of the insured and called into effect the obligation of the insurer as fully as payment to the treasurer of the claimant could have done." Maryland Casualty Co. v. United States, supra at 347. The premiums were the consideration for the risk underwritten by the insurance

> company, and payment to the agent was made to satisfy the obligation to pay the insurer. It was for this reason that the Court held that the principal, and not the agent, should be taxed.
>
> Thus, the notion established in Maryland Casualty Co., that an agent should not be taxed on amounts it receives as its principal's legal representative, depends upon the existence of some form of legal relationship between the principal and a third party. This Court and other courts have consistently required such a relationship. E.g. Johnson v. United States, 698 F.2d 372 (9th Cir. 1982); Johnson v. Commissioner, 78 T.C. 882, 891 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984); Pacella v. Commissioner, 78 T.C. 604, 619 (1982); Keller v. Commissioner, 77 T.C. 1014, 1027 (1981), affd. 723 F.2d 58 (10th Cir. 1983). In Johnson v. Commissioner, supra at 891, we stated that "there must exist between the corporation [the 'principal'] and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position."

The record makes clear that there was no contract between petitioner's Order and the State of California. Fairview, the employing State agency, had absolutely no contact with the Order. Fairview made its initial request for a priest with the Archdiocese, which in turn went to petitioner's Order. However, even had Fairview made its request to the Order directly, our conclusion would be no different. Neither the Order nor the Archdiocese had any legal obligation to provide the requested religious services to Fairview. We also note, however, that Fairview appeared to have little, if any, input into the choice of the Chaplain, that apparently being the province of the

Order.[7] In fact the record contains positive proof that no contract or obligatory relationship existed between the Order and Fairview.[8]

The only legal relationship created under the facts of this case is that of employer/employee between Fairview and petitioner. If Fairview were unhappy with petitioner's services, he could have been released with no liability to the Order. On the other hand, had the Order seen fit to reassign petitioner to some other position, there is no indication that the Order would be obligated to supply another priest or would be liable to Fairview in any way.

There is one factual difference between this case and Schuster which makes this case appear, at the first glance, more troublesome. This difference lies in the nature of the services performed by the respective parties. In Schuster, the taxpayer was performing duties which might be termed secular (nurse-midwife) while in this case petitioner performed no secular duties at all and served only as a priest. This difference, however, does not alter the fact that petitioner's Order was under no obligation to Fairview or vice versa. The State of California pays petitioner in satisfaction of its legal obligation to him as an employee. The Order is not involved at all, except as the recipient of petitioner's earnings when he endorses his checks over to the Order. See Schuster v. Commissioner, supra at 777-778.

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[7] Petitioner did file an application and was required after he had entered on duty by the State to elaborate on his pastoral training apparently to ensure he met the State civil service standards for Catholic Chaplain.

[8] Exhibit 4-D, which is a letter by Louis Britt, who is the Personnel Officer at Fairview, states:

> Fr. McEneany is paid through the State payroll system rather than direct payment to the Church or religious order since the State is prohibited from contracting for services that can be provided through the Civil Service system, which again in this case would be through the Civil Service classification of Catholic Chaplain.

The Court of Appeals, in Fogarty v. United States, 780 F.2d 1005 (Fed. Cir. 1986), has recently held that income received by Father Fogarty, a member of the Society of Jesus, as an associate professor at the University of Virginia, was earned in his individual capacity and not as an agent of his order. Fogarty, as petitioner herein, was bound to his order by vows of chastity, poverty and obedience. Teaching is an essential and traditional mission for the Jesuits. In affirming the decision of the Claims Court, the Federal Circuit agreed that the University looked to Father Fogarty, rather than his order, for the accomplishment of the services for which it bargained. The court stated that the relevant considerations will include the degree of control exercised by the order over the member, purposes or mission of the order, type of work performed by the member vis-a-vis those purposes or mission, dealings between the member and the employer and dealings between the employer and the order. The Federal Circuit, in holding for respondent, nevertheless recognized that the case was very close.

It may well be that the instant case is even closer. We recognize that Fairview made the overture to the Archdiocese to supply the Catholic Chaplain and they took the priest sent to them by the Order. Nevertheless, we fail to find the contractual relationship between the Order and Fairview herein. As in Schuster, petitioner earned his salary in his individual capacity and not as the Order's agent.

The Ninth Circuit in Johnson v. United States, 698 F.2d 372 (9th Cir. 1982), considered a professional basketball player who conveyed the exclusive rights to his services to a Panamanian corporation, but who played under contracts negotiated and executed by him with National Basketball Association teams. He then assigned the contracts to the corporation and contended that amounts received by the corporation did not constitute income to him as a "loaned out" employee. In rejecting Johnson's position, the Ninth Circuit made a two-pronged inquiry: (1) did the corporation have the right to control the activities of the individual and the amount of compensation the individual receives for those services and (2) whether this control has been recognized and accepted by the contracting party. If we apply this two-part test to the case at bar, it appears that petitioner might satisfy the first test but there is nothing to indicate that the second test is met. Fairview looks to petitioner, not to the Order, for the performance of his services. See also Hogan v. United States, an unreported case (Me. 1985, 57 AFTR 2d 86-338, 85-2 USTC par. 9846).

We have no doubt of the sincerity of Father McEneany's arguments nor of his faithful performance of his priestly duties at Fairview. We conclude that this is a close case which we hold controlled by our decision in Schuster.

Decision will be entered
for the respondent.

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UNITED STATES TAX COURT

DAVID C. RUTTENBERG AND SARAJEAN RUTTENBERG, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

DAVID W. RUTTENBERG AND MARILYN G. RUTTENBERG, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 14529-82,
14530-82.

Filed September 3, 1986.

Steven D. Lustig, for the petitioners.

Thomas J. Kane, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income tax as follows:

Petitioners	Year	Deficiency
David C. and Sarajean Ruttenberg	1978	$24,389
David W. and Marilyn G. Ruttenberg	1978	30,037

G. M. / VL

After a concession, the issue remaining for decision is whether a portion of the expenditures incurred in the renovation of two apartment buildings was repair expense currently deductible under section 162[1] or part of a general plan of improvement and rehabilitation which must be capitalized.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

During 1978, David C. Ruttenberg and Sarajean Ruttenberg, husband and wife, resided in Chicago, Illinois. During 1978, David W. and Marilyn G. Ruttenberg, husband and wife, also resided in Chicago, Illinois. David W. Ruttenberg (David or petitioner) is the son of David C. and Sarajean Ruttenberg (the mother or petitioner). Both David and his father are attorneys. David is well experienced in the urban real estate business, including the purchase and operation of both residential and commercial real estate. David and his mother (referred to jointly as petitioners herein) engaged in the real estate transactions involved in this case.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

In 1977, two Illinois land trusts in which David and his mother each had a 50 percent beneficial interest purchased the apartment buildings at 3507-3513 North Racine Avenue (hereinafter the Middle Racine building) and 3517-3525 North Racine Avenue (hereinafter the Eddy-Racine building). The Middle Racine building was purchased on or about June 1, 1977, and cost $200,000, of which $176,000 was allocated to the basis of the building. The Eddy-Racine building was purchased on or before May 1, 1977, and cost $260,000, of which $228,800 was allocated to the basis of the building. At all times during 1978, David and his mother each owned a 50 percent interest in both properties as tenants in common and not as joint tenants.

Petitioners and other members of the Ruttenberg family had been purchasing and operating small apartment buildings since the 1950's. The Ruttenberg family members, in addition to purchasing a variety of apartment buildings, had also purchased shopping centers and some small office buildings. David had personally overseen repairs and renovations on more than 500 apartments, more than 200,000 square feet of office space, and over 200,000 square feet of shopping centers. During the period 1975-1976, the Ruttenbergs expanded their real estate operations from residential properties in the Lincoln Park and DePaul areas of Chicago to contiguous, less expensive areas where they could purchase apartment buildings at lower prices, upgrade them, and rent them at higher prices than before renovation, comparable to but still a little lower than those prices prevailing in the Lincoln Park and DePaul areas. Thus, by 1977 the Ruttenbergs had purchased some seven apartment buildings, from six units up to 33 units, in the Wrigleyville area, including the only other building on the block containing the Middle Racine and the Eddy-Racine buildings. This third building, located at 3501-3503 North Racine Avenue/1150-1156 West Cornelia Avenue, underwent extensive renovations during 1977. Petitioners purchased the Middle Racine and the Eddy-Racine buildings in 1977 in continuation of the plan to attract younger tenants with higher incomes to Wrigleyville, an area where older, blue collar tenants had previously lived.

David and his mother operated the two buildings involved in this case as informal partnerships, agreeing orally to share profits and losses equally. From the time of acquisition in 1977 and throughout 1978, Jerome H. Meyer & Co. managed the apartment buildings pursuant to a written agreement between David and that company that covered these buildings as well as some 17 other buildings. Jerome H. Meyer & Co. was a general manager whose functions included the collection of rents and the disbursement of checks for any costs incurred during the day-to-day operation and renovation of the apartment buildings. The management company kept detailed records in the form of a management statement of receipts and disbursements for each building each month. All expenditures for both buildings, both the admittedly capital expenses and the expenses in dispute in this case, were recorded on these monthly statements.

During 1978, David directed and caused to be made significant renovations at both apartment buildings. Usually, on his way downtown to his law office, David stopped by the buildings about eight o'clock in the morning to direct the various tradesmen working that day. David was familiar with the work of most of the various tradesmen he employed, since they had worked on other Ruttenberg family projects. Because David and his family had had only a limited opportunity to inspect these two apartment buildings prior to purchase, the extent of the renovations may have exceeded petitioners' initial expectations. However, the record does not indicate the usual range of expenditures the Ruttenbergs incurred in renovating buildings they had purchased in the Wrigleyville area. Whether or not the extent of the necessary renovations may have exceeded petitioners' original expectations, most of the expenditures in this case were admittedly capital in nature.[2]

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[2] In light of David's extensive experience in the real estate business and that of his family, particularly the purchase and renovation in 1977 of the only other building on the block containing the two apartment buildings at issue, we do not wholly accept David's testimony regarding petitioners' original expectations. In any event, we think their expectations would not be relevant or material to any issue in this case. That the necessary renovations may have been more extensive than anticipated at the time of purchase of the buildings is not determinative. Many a harried rental property owner has called in a repairman to fix something (a deductible expense) only to

The renovation work on both apartment buildings was extensive. While petitioners may have tried to maintain some cash flow from some apartments that were occupied by tenants from the prior ownership, most of the work took place while the apartment buildings were largely vacant. Renovations on the Eddy-Racine building began in 1977 and continued over to 1978. The record does not disclose the nature of the work performed in 1977 or the cost thereof. Except for one apartment, the Eddy-Racine building was vacant the first three months of 1978. Most of the preexisting leases on the apartments in the Middle Racine building expired in April of 1978, and on or before that time, the apartments were vacant and the major renovations were under way in that building. Most of the apartments in that building remained vacant until September of 1978.

The interior of each apartment had work done in it when it was vacated by the tenants who were holdovers from the prior ownership, usually when the leases expired. When work in each apartment had been completed, the apartment was available to be relet at the increased rental amount. Generally that occurred about April or May of 1978 for the Eddy-Racine building and September of 1978 for the Middle Racine building. Twenty of the

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(footnote continued from previous page)
learn to his dismay that the item must be replaced (a nondeductible capital expenditure).

32 units in the Eddy-Racine building had been completed by May 1978. Work in the common areas of both buildings was done on a continuing basis throughout 1978.

The plumbing and wiring of both buildings were largely replaced. The boiler in the Eddy-Racine building was removed and independent electrical heating units were installed in each apartment. This required new electric service to the building with separate breaker boxes and metering services. The plumbing risers in the Eddy-Racine building were replaced, requiring extensive plastering in the bathrooms and kitchens. During 1978 the roof of the Eddy-Racine building leaked after completion of most of the interior renovations, requiring some of the work to have to be done over again. Both buildings received new appliances in almost every apartment. New cabinets, countertops, and sinks were installed in the kitchens of all the apartments. Throughout both buildings, many fixtures and structures did not work properly. For example, both buildings contained warped doors, malfunctioning window frames and sashes, broken glass, improperly maintained floors, and malfunctioning electrical outlets that had to be corrected. Both buildings required extensive painting, plastering, and drywall work. Carpentry work in both buildings included framing for kitchen cabinets and countertops, floors, and framing for new heating and air-conditioning systems.

In 1978, the classified section of the Chicago Tribune listed both apartment buildings as completely remodeled. After the renovations, David obtained appraisals of the fair market value of both apartment buildings as required to secure long-term mortgage financing. The Middle Racine building was apparaised at a fair market value of $586,000 and the Eddy-Racine building at $720,000, representing an increase over the original purchase price of 293 percent and 277 percent, respectively.

Relying on the records maintained by Jerome H. Meyer & Co., David separated the renovation expenditures into two categories: capital expenditures which were fully capitalized and what he called "housekeeping expenditures" which were partially capitalized and partially deducted as ordinary and necessary business expenses. David made his allocation of the "housekeeping expenditures" based on the increased fair market value of the apartment building as measured by the increase in rent after completion of the renovation. At the Middle Racine building, the average rent after the renovation increased from $165 to $280 per month, an increase of 69.7 percent. Accordingly, based roughly on this percentage increase, of the $239,435.14 which was expended for material and labor for work not related to a previously capitalized cost, petitioners capitalized $165,464.14 of that amount and deducted the balance of $73,971 as a current expense. The treatment of this $73,971 is in dispute in this case.

During 1978, petitioners spent a total of $303,872 on the Middle Racine building and characterized the expenses as follows:

Description	Capitalized	Deducted
New appliances	$48,918	
Electrical	28,150	
Plumbing and heating (including new heating system)	55,519	
Carpentry	27,000	$17,291
Plaster and lathe	20,025	12,933
New tile	7,200	
Masonry	9,200	
New porches and Floors	8,527	
New windows	6,195	
New ceilings	2,705	
General repairs	16,462	
Electrical		7,561
Roof		140
Painting		4,124
Cement and glazing		3,331
Appliances		1,988
Windows, shades, screens and floor		6,775
Plumbing		9,422
Ceilings and walls		5,901
Miscellaneous		4,505
Totals	$229,901	$73,971

In addition petitioners claimed $83,092 in ordinary and necessary business expenses for the Middle Racine building for the following items:

Advertising	$ 1,109	
Cleaning and Hauling	3,241	
Commissions	500	
Gardening	157	
Heating, fuel	818	
Insurance	3,442	
Interest	23,249	
Legal and accounting	380	
Maintenance	2,808	
Management fees	2,107	
Miscellaneous expense	146	
Office expense	509	
Pest control	225	
Salaries	7,221	
Supplies	14,039	
Taxes-property	13,683	
Taxes-payroll	188	
Utilities	8,872	
Pension & welfare fund	303	
Trust fees	55	
Bank fees	40	
Total other expenses		$83,092

Petitioners' informal partnership which operated the Middle Racine apartment building claimed an ordinary loss of $151,780 on its 1978 partnership information return which was filed on April 16, 1979. This loss was distributed equally to petitioners.

David followed the same procedure for allocating the so-called "housekeeping expenditures" for the Eddy-Racine building. There the average rent after the renovation increased from $165 per month to $260 per month, an increase of 57.6 percent. Accordingly, based on this percentage increase, of the $95,910.58 which was expended for material and labor for work unrelated to a previously capitalized cost, petitioners capitalized $58,130 of that amount and deducted the balance of $37,781 ($37,780.58) as ordinary and necessary business expenses. The treatment of this $37,781 is in dispute in this case.

During 1978, petitioners spent a total of $201,148 on the Eddy-Racine building and characterized the expenses as follows:

Description	Capitalized	Deducted
New appliances	$ 34,147	
Electrical	26,185	
Plumbing and heating (including new heating system)	24,527	
Carpentry	21,668	$10,834
Plaster and lathe	14,721	7,360
New tile	6,605	
Masonry	5,208	
New porches	3,801	
New windows	2,602	
New carpeting	2,844	
New ceiling	1,344	
New shades/screens	2,760	
Fireplaces	1,920	
General repairs	15,035	
Roof		3,007
Air conditioning		1,638
Cement and glazing		1,363
Appliances		497
Windows, shades, screens		2,681
Floor		1,769
Woodwork		4,735
Supplies		
Locks and keys		399
Carpentry		2,467
Building		759
Paint		272
Total	$163,367	$37,781

In addition, petitioners claimed $111,778 in ordinary and necessary business expenses for the following items:

Advertising	$ 1,737
Cleaning and hauling	5,853
Gardening	1,621
Heating, fuel	357
Insurance	5,213
Interest	47,604
Legal and accounting	520
Maintenance	9,510
Management fees	4,396
Miscellaneous expense	128
Salaries	11,921
Supplies	6,992
Taxes-property	10,887
Taxes-payroll	238
Telephone	65
Utilities	3,785
Janitor pension	387
Sewerage	
Other fees	293
Loan & finance costs	211

Total other expenses $111,778[3]

Petitioners' informal partnership which operated the Eddy-Racine building claimed an ordinary loss of $122,552 on its 1978 partnership information return which was filed on April 16, 1979. The loss was distributed equally to petitioners.

In 1980, after an audit of both partnership returns for 1978, respondent disallowed the treatment of the so-called housekeeping expenses. As a result, on March 26, 1982, David W. and Marilyn G. Ruttenberg received a notice of deficiency for

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[3] The parties stipulated to the total of $111,778, and that is the figure shown on the partnership return. However, the figures shown on the schedule attached to the return, which are tabulated in the text, add up to only $111,718. There is no explanation for this minor discrepancy, but one might surmise that a figure for sewerage had been inadvertently omitted.

1978 in the amount of $30,037. On the same day, David C. and Sarajean Ruttenberg received a notice of deficiency for 1978 in the amount of $24,389.

OPINION

The sole issue for decision is whether a portion of the so-called "housekeeping expenses" are currently deductible under section 162, as petitioners contend, or are part of a general plan of renovation and improvement of the two apartment buildings that must be capitalized under section 263, as respondent contends. Petitioners bear the burden of proof. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a).

Petitioners purchased two apartment buildings in the Wrigleyville area of Chicago, the Middle Racine and the Eddy-Racine buildings. Petitioners and other Ruttenberg family members had previously expanded their urban real estate business from the Lincoln Park and DePaul areas of Chicago into the contiguous, less expensive Wrigleyville area, with the purchase of some seven other apartment buildings in Wrigleyville in the period from 1975 to 1977. The Ruttenbergs purchased apartment buildings in Wrigleyville, renovated them, and tried to attract younger professionals with higher incomes into this area which had formerly housed older, blue collar tenants. Petitioners' purchase of the Middle Racine and Eddy-Racine buildings was a continuation of that effort. During 1978, petitioners completed major renovations of both apartment buildings.

Petitioners spent $303,872 on the Middle Racine building and $201,148 on the Eddy-Racine building, these expenditures representing 152 percent and 77 percent, respectively, of the original purchase price of the buildings. Of those total expenditures, petitioners treated $239,435.14 at the Middle Racine building and $95,910.58 at the Eddy-Racine building as what they called "housekeeping expenses," which petitioners partially capitalized and partially deducted as ordinary and necessary business expenses. Petitioners made that allocation of the "housekeeping expenses" based on the percentage of increase in the rents before and after the renovations. For example, the rent for an apartment at the Middle Racine building increased from $165 to $280 per month, an increase of 69.7 percent. Thus, of the $239,435.14 "housekeeping expenses" for that building, petitioners capitalized $165,464.14 of that amount, roughly 69 to 70 percent, and deducted the balance of $73,971. Petitioners made a similar allocation for the Eddy-Racine building expenses. Thus, petitioners deducted $73,971 of the "housekeeping expenses" at the Middle Racine building and $37,781 of the "housekeeping expenses" at the Eddy-Racine building. These are the amounts in dispute in this case.

Whether an expense is deductible or must be capitalized is a question of fact. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 337 (1962). Expenses in the nature of a repair keep something in ordinary operating condition and do not add value to the asset. Section 1.162-4, Income Tax Regs.; Bloomfield Steamship Co. v. Commissioner, 33 T.C. 75, 84-85 (1959), affd. per curiam 285 F.2d 431 (5th Cir. 1961); Jones v. Commissioner, 24 T.C. 563, 568 (1955), affd. 242 F.2d 616 (5th Cir. 1957); Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106-107 (1926). In contrast, capital expenditures create a new asset having a useful life of more than one year. Section 1.263(a)-1, 2, Income Tax Regs. The Court in Illinois Merchants Trust Co. outlined the distinction between a capital expense and a deductible business expense as follows:

> To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. * * * [Illinois Merchants Trust Co. v. Commissioner, supra, 4 B.T.A. at 106.]

Expenses incurred as part of a plan of capital improvement must be capitalized even though the same expense if incurred separately would be deductible as an ordinary and necessary business expense. United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968); Stoeltzing v. Commissioner, 266 F.2d 374 (3d Cir.

1959); Jones v. Commissioner, 242 F.2d 616 (5th Cir. 1957); Cowell v. Commissioner, 18 B.T.A. 997 (1930).[4] Unanticipated expenses that would be deductible as a business expense if incurred in isolation must be capitalized when incurred pursuant to a plan of rehabilitation. California Casket Co. v. Commissioner, 19 T.C. 32 (1952).[5] Whether there is a plan of capital improvement is a question of fact. United States v. Wehrli, supra; Home News Publishing Co. v. Commissioner, 18 B.T.A. 1008 (1930).

Petitioners argue that Cowell v. Commissioner, supra, limits the plan doctrine to taxpayers whose records do not support an accurate allocation between sections 162 and 263. While petitioners insist that the Court must look at this case on an item-by-item basis and decide on an item-by-item basis whether the particular expense is a currently deductible repair expense or a capital expenditure that must be capitalized, petitioners did not provide a record to permit us to do so. In preparing their partnership returns, at trial, and on brief petitioners relied on a percentage allocation that is singularly unrelated to the item-by-item analysis they say the Court must make.[6] In any event, although the Court in Cowell, supra, 18 B.T.A. at 1002, referred to the inadequacy of that taxpayer's records, subsequent cases require capitalization of all expenditures incurred pursuant to a plan of renovation or improvement whether or not the records are adequate. United States v. Wehrli, supra, 400 F.2d at 689, 690.[7] California Casket Co. v. Commissioner, supra, 19 T.C. at 37. Petitioners cite Churchill Farms, Inc. v. Commissioner, T.C. Memo. 1969-192, affd. in part and revd. in part on other grounds sub nom. Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971), for the proposition that a plan of capital improvement can coexist with ordinary and necessary business expenses. In Churchill the disputed expenditures, improving a 4,200 acre multi-use tract of land, were arguably incurred pursuant to several plans of improvement, including the construction of a caretaker's building and an access road across a marsh and general maintenance. The Court stated:

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[4] See also Moss v. Commissioner, T.C. Memo. 1986-128, on appeal (9th Cir., June 30, 1986); Seahill Co. v. Commissioner, T.C. Memo. 1964-56; and Bank of Houston v. Commissioner, T.C. Memo. 1960-110.

[5] See also La France Wine Co. v. Commissioner, T.C. Memo. 1974-254.

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[6] Even in those instances where certain work had to be redone after the roof of the Eddy-Racine building leaked, work that might possibly be classified as repairs rather than part of the plan of renovation and rehabilitation, petitioners did not favor us with information that might identify those items of work and the expenses relating thereto.

[7] See also Moss v. Commissioner, supra; Seahill Co. v. Commissioner, supra; Bank of Houston v. Commissioner, supra; 4A J. Mertens, Law of Federal Income Taxation, sec. 25.56, at 217, 221, nn.22-28 (1985 rev.).

> We recognize the validity of the rule that the cost of an item which is part of a plan of rehabilitation and modernization must be capitalized, even though, standing alone, the item may appropriately be classified as repair. But, notwithstanding the fact that certain of the expenses may be of value when and if petitioner decides to develop its property for residential or commercial uses, as we view the evidence the plans for developing the land were too nebulous in the years before us to justify treating all otherwise currently deductible expenses as capital expenditures. [Churchill Farms, Inc. v. Commissioner, 28 TCM 990, 1004, 38 P-H Memo T.C. par. 69,192 at 69-1087.]

Petitioners' expenditures, on the other hand, renovated two apartment buildings specifically to attract wealthier tenants. There was nothing nebulous or uncertain about petitioners' plan.

Petitioners also argue that the plan doctrine applies only when the taxpayer prepares a written plan or employs a recognized specialist such as an architect, engineer, or general contractor. We do not think the doctrine is so narrowly confined. In Home News Publishing Co. v. Commissioner, supra, 18 B.T.A. at 1010, the Court emphasized a scheme. In Stoeltzing v. Commissioner, supra, 266 F.2d at 376, 377, the Court did not address any of petitioners' proposed limitations. In general, the courts look more at results than preconditions. Here, even assuming petitioners started out intending to make just a few repairs and cosmetic changes to these buildings, which we doubt, nevertheless it is clear that what developed was a full-blown renovation and improvement plan. As to the other purported limitation, the need for a general contractor, it is hard to imagine a definition of general contractor that would exclude David W. Ruttenberg, who had such extensive experience with apartment building renovations. Of course, we do not agree that the plan doctrine is so limited as to require a general contractor or other supervisor of the project.

Finally, petitioners argue that expenses incurred after occupation of the apartments were not part of the plan of renovation and should be deductible as ordinary and necessary business expenses. In this argument, petitioners presumably accept the existence of a plan of general betterment. However, petitioners do not demonstrate why the renovation plan ends with occupancy of any one apartment or group of apartments. Moreover, while there are records of each and every expenditure on both buildings, petitioners made no attempt to segregate those expenditures that were incurred after occupancy and that might arguably be treated as currently deductible repair expenses. Instead petitioners simply allocated the so-called "housekeeping expenses" on the basis of the percentage of increase in rents after the renovation.

David was experienced in the urban real estate business in general, and in the real estate business in the Wrigleyville area in particular. Petitioners hoped to attract young professionals, capable of paying higher rents, to their renovated apartment buildings, which were advertised in the local newspaper as completely remodeled. The value of both buildings increased dramatically after the renovations. Following the renovations, the Middle Racine building was appraised at a fair market value figure of 293 percent of the amount petitioners originally paid for the building, and Eddy-Racine at 277 percent of its original purchase price. Based on the record as a whole, we conclude that there was a plan of renovation and rehabilitation for the two apartment buildings and that all of the expenditures on these buildings must be capitalized.[8]

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[8] We do not include of course those admittedly deductible current expenses. Respondent accepted $83,092 of ordinary and necessary business expenses, including $2,808 for maintenance, at the Middle Racine building and $111,778 of ordinary and necessary business expenses, including $9,510 for maintenance, at the Eddy-Racine building.

We reject petitioners' position that some of the expenditures incurred pursuant to the plan of renovation are deductible as ordinary and necessary business expenses. We conclude that all of the expenditures incurred pursuant to the plan must be capitalized.

To reflect the concession and the above holding,

Decision will be entered for respondent in docket No. 14529-82.

Decision will be entered under Rule 155 in docket No. 14530-82.

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UNITED STATES TAX COURT

MARCUS CONANT AND ANNE L. CONANT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 12605-79, 1411-81. Filed September 3, 1986.

From 1974 through 1976, petitioner-husband's primary business was as a Texaco consignee; he was also an officer, an employee, and a shareholder of three corporations--EASI, CAN DO, and ECO-REZ. These corporations were operated separately from each other and were not related to petitioner-husband's business as a Texaco consignee. In 1974, petitioner-husband guaranteed a note on behalf of EASI and a note on behalf of ECO-REZ. Neither of these corporations paid the notes. Petitioner-husband made payments on account of these guarantees. From 1974 through 1976, petitioner-husband made expenditures on behalf of the three corporations. CAN DO was dissolved in 1976.

In 1976, petitioners did not report any dividend income from Santa Fe Fuels, Inc.

Held: (1) Petitioner-husband's 1974 and 1975 payments on account of his guarantee of the EASI note gave rise to nonbusiness bad debts, deductible as short-term capital losses for the years in which the payments were made. Sec. 166(d), I.R.C. 1954.

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(2) Petitioner-husband's 1976 payments on account of his guarantee of the ECO-REZ note gave rise to business bad debts, deductible in full against gross income for 1976. Sec. 166(a), I.R.C. 1954.

(3) Petitioner-husband's expenditures on behalf of EASI, CAN DO, and ECO-REZ were contributions to the capital of the respective corporations.

(4) Petitioners are entitled to a 1976 long-term capital loss deduction for petitioner-husband's contributions to CAN DO's capital.

(5) Petitioners failed to prove (a) that they are entitled to deduct items that respondent had disallowed as personal or unverified, and (b) that they had no dividend income from Santa Fe Fuels, Inc.

(6) Liability determined for additions to tax under sec. 6653(a), I.R.C. 1954, for 1974, 1975, and 1976.

Thomas G. Christmann, for the petitioners.

Avery Cousins, III, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, Judge: Respondent determined deficiencies in Federal individual income taxes and additions to tax under section 6653(a)[1] (negligence, etc.) against petitioners as follows:

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[1] Unless indicated otherwise, all section and chapter references are to sections and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

Docket No.	Year	Deficiency[2]	Additions to Tax Sec. 6653(a)
12605-79	1974	$ 9,269.88	$ 463.49
	1975	7,585.83	379.29
1141-81	1976	11,717.97	585.90

These cases have been consolidated for trial, briefs, and opinion.

After concessions by respondent, the issues for decision are as follows:

(1) Whether petitioners are entitled to deduct their claimed Schedule C business expenses for 1974, 1975, and 1976;

(2) Whether petitioners received unreported dividend income in 1976; and

(3) Whether petitioners are liable for an addition to tax under section 6653(a) for each of the years in issue.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petitions were filed in the instant cases, Marcus Conant (hereinafter sometimes referred to as "Conant") and Anne L. Conant, husband and wife, resided in Gainesville, Florida.

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[2] Of these amounts, self-employment taxes under chapter 2 are $1,042.80 for 1974, $1,113.90 for 1975, and $1,208.70 for 1976; the remaining amounts are chapter 1 income taxes.

During the 1930's, Conant was an employee of the Internal Revenue Service (hereinafter sometimes referred to as "the IRS"). When Conant left the IRS he was chief of an audit section. Conant had been in the United States Army (or Army Reserves) for 27 years; during World War II, he spent 42 months overseas. During the years in issue, Conant was a retired military officer and he received a pension for his service in the United States Army.

In 1945, Conant became involved with dredges. In the late 1960's, Conant started building an 8-inch dredge. He had this dredge throughout the 1970's. Conant maintained a shop in his garage at home; he had lathes, grinders, and welders. In the shop, Conant was developing an improved cutter head for a dredge, and a model of a bomb shelter. Conant applied for a patent on his bomb shelter.

From 1974 through 1976, Conant's primary business was as a Texaco consignee, operating from offices in Gainesville, Florida. As a Texaco consignee, Conant sold Texaco products for commission.

Texaco would assist an individual in establishing a service station by financing 90 percent of the cost of a service station and the land. Conant believed that if he had a piece of land dredged and traded it for a service station site then he could receive a 100-percent mortgage on the property.

From 1974 through 1976, Conant also was an employee, officer, and shareholder of the following three corporations: (1) Environmental Aquatic Services, Inc. (hereinafter sometimes referred to as "EASI"); (2) CAN DO, Inc. (hereinafter sometimes referred to as "CAN DO"); and (3) ECO-REZ, Inc. (hereinafter sometimes referred to as "ECO-REZ"). Each of these corporations was operated separately from the others and was not related to Conant's business as a Texaco consignee.

Background--EASI

EASI was incorporated on November 15, 1971. EASI was authorized to issue 100 shares of common stock, par value $5. The original shareholders of EASI were Arthur E. Barrett (hereinafter sometimes referred to as "Barrett"), EASI's president, and Paul B. Drewing (hereinafter sometimes referred to as "Drewing"), EASI's secretary/treasurer; each shareholder had 20 shares of stock. In January 1973, Drewing transferred his EASI stock to First National Bank of Florida as collateral against a $2,000 loan; these 20 shares were later retired. In January 1973, Conant became office manager/director/treasurer of EASI and bought 20 shares of stock. In late 1973, Sherill Alesi (hereinafter sometimes referred to as "Alesi"), became secretary of EASI. Alesi did not own EASI stock.

Conant's job with EASI was to manage all EASI funds. Barrett was responsible for soliciting work for EASI, checking that the work was done properly, and maintaining EASI's equipment. Initially, Conant maintained all of EASI's records in

Gainesville. However, sometime in 1973 or 1974, Conant turned over most of the recordkeeping duties to Alesi, who lived in Georgia. While Conant initially controlled EASI's checking accounts with ComBank/Pine Castle, Pine Castle, Florida, the First National Bank of Gainesville (hereinafter sometimes referred to as "First Bank"), and the Florida National Bank of Gainesville, the actual check-writing duties were for the most part transferred to Alesi in 1973. In 1973, Conant advanced more than $6,000 to EASI.

Federal employment tax Forms 941 were filed for EASI for the years in issue. A corporate tax return Form 1120 was filed for EASI on June 18, 1973, for the calendar year 1972. There is no record of any further corporate tax return filing by EASI. EASI failed to make Federal income tax withholding and Social Security payments to the IRS for the period of September 30, 1973, through March 31, 1975. The IRS considered Conant responsible for the lack of payments, and garnished $4,142.33 of his military retirement pay. On September 5, 1979, Conant filed a refund claim for the $4,142.33.

EASI was apparently dissolved in 1977 and reinstated in 1979 to pursue some lawsuits.[3]

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[3] The record does not provide an explanation as to the nature of the lawsuits.

Background--CAN DO

CAN DO was incorporated by Conant in Florida about 1946 in order to operate dredges and earth-moving equipment. CAN DO was owned solely by Conant. At one time, CAN DO performed services for Conant's Texaco distributorship by fixing service stations and repairing pumps. Because of the high-risk nature of the work, Conant used the corporate form to limit his exposure to liability. CAN DO was dissolved in 1976.

Background--ECO-REZ

ECO-REZ was apparently incorporated in New York in 1974. The incorporators were Harry Trussell (hereinafter sometimes referred to as "Trussell"), Trussell's wife, and Conant. Trussell and Conant each had a 50-percent interests in ECO-REZ. ECO-REZ's officers were Conant (president), Trussell (treasurer), and Trussell's son, Carrie (secretary). The business was intended to recycle various waste plastic/vinyl materials into reuseable vinyl resins, which in turn could be used as raw materials for producing finished products.

Conant's Activities Apart From His Business as a Texaco Consignee

In 1973, Conant and Barrett arranged to purchase a 10-inch dredge from a man named Taylor for about $20,000. When the deal was made, Conant and Barrett each paid Taylor about $2,500. Conant contributed his interest in the dredge to EASI. The dredge was to be used at Lake Wicata, Florida; the dredging job was halted because a State dredging permit was not obtained. EASI received $15,000 for the work performed.

In 1973, Conant loaned Barrett some money.[4] Petitioner Anne L. Conant was concerned about the financial stability of both Barrett and EASI. She made Conant promise to have no further dealings with Barrett and EASI. Conant continued his business relationship with Barrett and EASI because he wanted his money back.

In August 1973, Barrett told Conant that EASI was to be sold for $300,000 to AMAX Resources Recovery, Inc. (hereinafter sometimes referred to as "AMAX"), a wholly-owned subsidiary of AMAX, Incorporated. Thereafter, Barrett took all of Conant's EASI accounting records. The sale of EASI to AMAX was to be made in January 1974 and then Barrett was to work for AMAX. Barrett told Conant that AMAX was developing a product to neutralize military radar. Conant related this information to the Federal Bureau of Investigation (hereinafter sometimes referred to as "the FBI"). After about 2 years, the FBI informed Conant that the files on the case were destroyed.

The sale of EASI to AMAX never took place; instead EASI sold only the 10-inch dredge to AMAX. Conant did not receive any of the proceeds from this sale to AMAX.

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[4] The record fails to indicate how much money was involved.

Taylor sued Conant to recover the outstanding debt owed to Taylor on the purchase of the 10-inch dredge. After Conant told Taylor that he had contributed his interest in the dredge to EASI, Taylor amended his suit to include EASI.

In September 1973, Conant leased his 8-inch dredge for use on a dredging job in Smyrna, Georgia. The dredge was moved to the site. Conant never received any money for the use of his dredge; he even had difficulty in having his dredge returned.

In 1974, Conant guaranteed a note on behalf of EASI to First Bank.[5] EASI did not repay the note and, in 1974 and 1975, petitioners paid $7,871.58 and $10,337.43, respectively, on account of Conant's guarantee on the note for EASI.[6]

On February 23, 1974, Trussell visited Conant at Conant's "bulk plant". Trussell indicated to Conant that he wanted to remove all of the equipment from a compost plant in Gainesville, Florida. Conant assisted Trussell by sending a machine to help move some of the equipment from the compost plant. Thereafter, Trussell contacted Conant to see if Conant could obtain some benzene for use by Allied Polymer, a corporation in Swainesborough, Georgia. If benzene were combined with other materials in Allied Polymer's molding injection machines, then perhaps a marketable product could be produced. At the time, Allied Polymer was suffering some financial difficulties; it had an insufficient supply of raw materials to operate.

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[5] The record fails to indicate the amount of the note guaranteed by Conant.

[6] It does not appear that any such amounts were paid in 1976.

During 1974, benzene was in limited supply in the United States. Conant contacted his son, a Texaco sales manager in Ireland, about the availability of the chemical. Based on his son's advice, in May 1974, Conant went to Ireland and made arrangements to purchase some benzene. On his return from Ireland, Conant was informed by Texaco that benzene was too dangerous to ship; instead Texaco suggested that a styrene monomer be substituted. The arrangement was that Conant would supply Allied Polymer with the chemical through his Texaco consignee business; Conant would receive a commission on the sales to Allied Polymer. Conant estimated that he would receive a minimum of $10,000 in commission from the sale of the chemicals to Allied Polymer. There was also some discussion that ECO-REZ and Allied Polymer would form a joint operation to produce the product.

While Conant was in Ireland in 1974, Allied Polymer issued about $70,000 in bad checks, drawn on the Citizens Bank of Swainesborough (hereinafter sometimes referred to as "the Citizens Bank"). When Conant returned, he became involved with Allied Polymer's financial problems. Later that year, Conant arranged that ECO-REZ would borrow $72,000 from the Citizens Bank, with the note guaranteed by Conant, Trussell, and another individual.

Conant guaranteed the note because he believed that Allied Polymer was worth saving. Conant and Trussell also arranged that Allied Polymer's accounts receivable were to be assigned to them, and then factored to provide additional funds for the corporation. It was intended that ECO-REZ would assist Allied Polymer directly with its financial difficulties. However, instead of ECO-REZ receiving the $72,000, the money was placed directly into Allied Polymer's bank account, which was used to pay the checks Allied Polymer had previously issued.

Conant also became Allied Polymer's treasurer. After several weeks, he resigned when he learned that Allied Polymer's past failure to pay withheld Social Security taxes to the IRS in a timely manner placed the treasurer personally at risk.

By a letter dated July 25, 1974, Allied Polymer ordered from Conant, 40,000 gallons of liquid styrene monomer to be delivered each month for the rest of the year. After receiving the letter, Conant contacted Allied Polymer to confirm the order; at this time Allied Polymer informed Conant that it was intending to purchase the chemical for resale purposes. Conant became upset and he refused to supply Allied Polymer with the chemical.

The $72,000 note to the Citizens Bank was not repaid. The Citizens Bank sued Conant, as one of the guarantors on the note.[7] The Citizens Bank won a judgment and levied on some of the commission checks Conant received from Texaco. In 1976, the

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[7] The record fails to indicate if the Citizens Bank also sued the other two guarantors.

Citizens Bank received $3,987.40.[8] The judgment was appealed on numerous occasions and finally Conant received a release from the Citizens Bank for the remainder of the debt. Conant's attorney's fees exceeded $30,000.

On or about October 20, 1974, William J. Duerr and his wife, Doris Ann Duerr, entered into a joint venture agreement with Trussell for the purpose of consolidating and developing their joint interests in the solid and liquid waste industry.

On January 6, 1975, Trussell, as president of Tech Rand Associates of Georgia, Inc. (hereinafter sometimes referred to as "Tech Rand"), entered into a contract with Richard E. Brown (hereinafter sometimes referred to as "Brown"), wherein Brown agreed to supervise the disassembly of two compost plants owned by Tech Rand, located in Gainesville and St. Petersburg, Florida. The contract was never carried out and Conant handled the disassembling and the shipping of the compost plant located in Gainesville. Conant did not receive any money for his services.

On February 5, 1975, Conant loaned $15,000 to Eugene F. Vickery (hereinafter sometimes referred to as "Vickery") to do a dredging job in Stuart, Florida. Vickery also leased some equipment from Conant and CAN DO for this job. The dredge used on the job was leased from someone other than Conant and CAN DO. Vickery never repaid any money to Conant. Conant did not sue Vickery.

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[8] Petitioners chose to deduct this item on their 1976 tax return as "returns and allowances", but inked in the explanation "garnishment". See table 3, infra. Respondent does not contend that this affects the validity of the tax return. See Beard v. Commissioner, 82 T.C. 766 (1984), affd. 793 F.2d 139 (CA6 1986)..

In 1976, Barrett was using a 6-inch dredge, owned by EASI, on the Chattahoochee River. Someone cut the dredge loose and it floated down the river. Conant loaned some money to Barrett to enable Barrett to retrieve the dredge.[9]

In 1974, 1975, and 1976, Conant made some expenditures on behalf of EASI and ECO-REZ. In 1974 and 1976, Conant made some expenditures on behalf of CAN DO. The expenditures were made to pay debts of the corporations, to keep the corporations continuing as going concerns, and to protect Conant's capital investments in the corporations. The corporations did not require Conant to make the expenditures. The corporations did not pay any amounts to Conant on account of these expenditures. Conant never sued for reimbursement of the expenditures made on behalf of the three corporations.

No loan documentation was ever prepared evidencing the expenditures to be loans from Conant to the respective corporations.

Conant never received any income from EASI, CAN DO, or ECO-REZ.

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[9] The record does not indicate whether Barrett repaid any money to Conant.

The Tax Returns

On their tax returns for 1974, 1975, and 1976, petitioners reported Schedule C net losses of $8,469.65, $10,524.37, and $13,112.65, respectively.

For 1974, respondent made adjustments to the Schedule C as listed in table 1, resulting in a net profit of $29,576.42.

Table 1

	Per Return	Adjustments
Gross receipts Less Returns And Allowances	$96,249.40	
Cost of goods sold:		
Cost of labor	21,671.00	($ 912.84)
Materials & supplies - shop expense	3,283.06	(1,687.13)
Other costs - bulk plant & station expense	15,047.44	322.06
Total cost of goods sold	$40,001.50	($2,277.91)
Gross profit	$56,247.90	$ 2,277.91
Deductions:		
Depreciation	6,481.68	(1,780.00)
Taxes	9,802.67	(4,078.16)
Rent	2,531.62	(2,434.56)
Utilities	3,418.20	(2,052.77)
Insurance	4,511.75	(1,513.84)
Legal & professional fees	5,581.65	(5,581.65)
Truck expense	14,987.60	(6,038.54)
Travel & entertainment	4,617.64	(3,838.38)
Interest expense	2,237.74	(1,126.22)
Equipment rental	5,577.47	(5,550.96)
Office expense	2,180.34	(859.99)
Advertising and promotion	1,486.49	(750.23)
Freight	337.30	(162.86)
Postage	965.40	—
Total deductions	$64,717.55	($35,768.16)
Net profit or (loss)	($8,469.65)	$38,046.07

Respondent determined that petitioners are entitled to treat the following as 1974 short-term capital losses:

(1) $7,871.58 paid by Conant to First Bank on account of Conant's guarantee on a note from EASI;[10] and

(2) $28,123.97 paid by Conant on behalf of EASI ($10,244.63), CAN DO ($7,318.17), and ECO-REZ ($10,561.17), and included in the "Adjustments" column of table 1, *supra*.[11]

For 1975, respondent made adjustments to the Schedule C as listed in table 2, resulting in a net profit of $22,499.11.

Table 2

	Per Return	Adjustments
Gross receipts Less Returns And Allowances	$91,964.64	
Cost of goods sold:		
Cost of labor	23,389.50	
Materials & supplies - truck expense	11,714.22	($1,956.04)
Other costs - bulk expense	2,433.55	(872.87)
Total cost of goods sold	$37,537.27	($2,828.91)[12]

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[10] Apparently, respondent now contends that only $7,738.72 was so paid, and that the remaining $132.86 is a personal payment to "AMEX", which we assume is the entity we refer to as "AMAX".

[11] Because of the manner in which respondent's determinations are presented in the notice of deficiency, we are unable to ascertain which of the Schedule C adjustments were determined to be currently recognizable short-term capital losses and which were determined to fall into other categories (e.g., personal expenditures or contributions to capital of one or another of the corporations).

[12] On the notice of deficiency, respondent erroneously failed to include this adjustment in parentheses, indicating that this adjustment is to be added to petitioners' total cost of goods sold on the Schedule C. However, this error by respondent does (footnote continued)

Gross profit	$54,427.37	$ 2,828.91
Deductions:		
Depreciation	9,065.68	(3,157.00)
Taxes	10,401.27	(4,588.79)
Rent	3,111.23	(538.70)
Repair (shop expense)	2,846.66	(848.58)
Insurance	5,431.55	(1,035.55)
Legal and professional fees	8,988.62	(7,617.62)
Utilities	4,474.78	(1,818.00)
Interest	2,308.35	(111.31)
Station expense	3,565.33	(1,183.09)
Travel and entertainment	4,484.20	(3,755.96)
Office expense	2,691.80	(1,357.66)
Advertising and promotions	2,314.75	(1,014.74)
Postage and freight	1,133.77	(146.12)
Equipment rental	4,133.75	(3,021.45)
Total deductions	$64,951.74	($30,194.57)
Net profit or (loss)	($10,524.37)	$33,023.48

Respondent determined that petitioners are entitled to treat the following as 1975 short-term capital losses:

(1) $10,337.43 paid by Conant to First Bank on account of Conant's guarantee on a note from EASI; and

(2) $12,364 paid by Conant on behalf of EASI ($2,749.07) and ECO-REZ ($9,614.93), and included in the "Adjustments" column of table 2, _supra_. (See n. 11, _supra_.)

(footnote continued from previous page)
not affect his determination that the revised amount of petitioners' total cost of goods sold is $34,708.36.

For 1976, respondent made adjustments to the Schedule C as listed in table 3, resulting in a net profit of $26,690.64.[13]

Table 3

	Per Return	Adjustments
Gross receipts	$47,124.96	$
Less: Returns and allowances	3,987.40	(3,987.40)
Total income	$43,137.56	$ 3,987.40[14]
Deductions:		
Depreciation	3,765.00	(538.00)
Taxes	807.56	(237.45)
Rental	2,865.25	(2,865.25)
Repair	965.96	(965.96)
Salaries	8,399.00	-0-
Insurance	1,439.51	(564.16)
Legal and Professional fees	4,450.95	(4,431.10)
Utilities	3,058.10	(1,720.80)
Interest	1,107.21	177.76
Bad debts	750.00	(750.00)
Freight	2,038.31	(1,424.08)
Station Expense	1,799.27	(1,200.31)
Bulk plant	1,692.25	(565.71)
Travel and entertainment	9,290.90	(9,164.90)
Truck expense	3,345.13	(1,659.13)

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[13] In the notice of deficiency, respondent determined that Conant's net profit was $26,690.64; this is the correct algebraic sum of (1) the loss petitioners reported on their tax return, and (2) the adjustments in the notice of deficiency. However, the parties' written stipulation states that, in the notice of deficiency respondent determined that Marcus' net profit was $26,640.64. It is not clear whether (a) the written stipulation contains a typographic error that persists in a subsequent oral stipulation, or (b) the written stipulation corrects an error in the notice of deficiency, or (c) the oral stipulation corrects an error in the written stipulation. The parties are to resolve this matter in the computation under Rule 155.

Unless indicated otherwise, all rule references are to the Tax Court Rules of Practice & Procedure.

[14] On the notice of deficiency, respondent erroneously enclosed this adjustment in parentheses, indicating that this adjustment is to be subtracted from petitioners' total income on the schedule C. However, this error by respondent does not affect his determination that the revised amount of petitioners' "Total income" is $47,124.96.

Office	734.64	(705.63)
Promotional	453.46	(378.46)
Postage	633.00	(168.00)
Equipment rent	8,654.71	(8,654.71)
Total deductions	$56,250.21	($35,815.89)
Net profit or (loss)	($13,112.65)	$39,803.29

For 1976, respondent did not determine that any of the disallowed Schedule C business expenses are deductible as short-term capital losses.

Petitioners did not report any capital gains or losses on their 1974 and 1975 tax returns. On their 1976 tax return, petitioners reported net short-term capital gains of $398.79[15] and net long-term capital gains of $353.70.[16] Of the eight capital assets sales petitioners reported on their 1976 tax return, three were of assets acquired in 1974, four were of assets acquired in 1975, and one was of an asset acquired in 1976.

Respondent examined petitioners' tax return for 1973. Respondent audited only some of petitioners' expenses; it was determined that petitioners owed an additional $184 in income taxes.

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[15] Three transactions, resulting in gains of $107.46 and $331.25, and a loss of $39.92.

[16] Five transactions, resulting in gains of $119.63, $162.05, $80.97, and $411.64, and a loss of $420.59.

Although petitioners claimed large deductions on their tax returns for 1974, 1975, and 1976, petitioners did not maintain adequate records and as a result, at trial, they were incapable of substantiating some of their claimed deductions.

* * * * * * *

Petitioners were negligent in failing to keep adequate records, and this negligence resulted in at least part of their underpayments for 1974, 1975, and 1976.

During the years in issue, Conant was in the trades or businesses of being a Texaco consignee, and of being an officer and employee of EASI, CAN DO, and ECO-REZ.

During the years in issue, Conant was not involved in any joint venture or co-venture with any corporation.

Apart from Conant's payments on account of his guarantees, Conant's expenditures on behalf of EASI, CAN DO, and ECO-REZ were not loans to the corporations.

Apart from Conant's payment on account of his guarantee of the ECO-REZ note, Conant's expenditures on behalf of EASI, CAN DO, and ECO-REZ were not related to Conant's trades or businesses or his income-producing activities.

Conant's attempt to provide Allied Polymer with benzene and styrene monomer was an activity of Conant's business as a Texaco consignee. Conant's guarantee of ECO-REZ's note to the Citizens Bank was part of this activity. The debt from ECO-REZ to Conant that arose when the Citizens Bank levied on some of Conant's Texaco commission checks was a debt created in connection with Conant's trade or business as a Texaco consignee.

OPINION

I. Schedule C Business Expenses--1974-1975

Respondent maintains that for 1974 and 1975, the disallowed Schedule C business expenses (apart from those disallowed as personal or unverified)--

> should be deductible only as non-business bad debts under section 166(d) of the Internal Revenue Code of 1954. As such, they would be treated as short-term capital losses and be deductible only in the taxable year in which they became worthless (and only in the amount of $1,000 per year for the years 1974, 1975 and 1976). I.R.C. § 166(d)(1)(B). This short-term capital loss treatment was given by respondent to the claimed deductions relating to the corporations which clearly had become losses during the 1974 and 1975 years, and was also the reason respondent modified its asserted tax deficiency for the 1976 year so as to allow petitioners a $1,000 short-term capital loss carryover for that year as well.

Petitioners maintain that the expenses disallowed by respondent for the years in issue should be deductible under section 162, section 212, section 166, or section 165.

We agree in general with respondent's conclusion that petitioners are entitled to a short-term capital loss deductible against gross income to the extent of $1,000 for 1974 and 1975.

As a preliminary matter, it is important to determine what trades or businesses Conant carried on[17] during the years in issue. The term "trade or business" is not defined in section 162.[18] Green v. Commissioner, 74 T.C. 1229, 1234-1235 (1980). Although various factors have been considered in determining whether a taxpayer's activities are a trade or business, each of these factors is only a guide and no one factor is conclusive. Higgins v. Commissioner, 312 U.S. 212, 217 (1941); Green v. Commissioner, 74 T.C. at 1235, and cases there cited.

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[17] Petitioners do not contend that petitioner Anne L. Conant carried on a trade or business during the years in issue. As a result, we focus exclusively on Conant's activities in our analysis.

We have found, that from 1974 through 1976, Conant was in the trades or businesses of being a Texaco consignee, and of being an officer and employee of EASI, CAN DO, and ECO-REZ. Petitioners contend that Conant was also in the trades or businesses of being an independent dredge operator, and dredge lessor, a compost plant disassembler, an inventor, and "a co-venturer in these capacities with the corporations". We disagree. Viewing the record as a whole, we are convinced that during the years in issue, Conant did not carry on any of these other trades or businesses as petitioners contend. Although we reach this conclusion on the basis of the entire record, there are several factors which deserve brief discussion.

Firstly, EASI, CAN DO, and ECO-REZ were separate corporate entities. More important, each of the corporations was separate from Conant. Conant was not in the trades or businesses of the corporations. This separation is as true of CAN DO, which Conant incorporated and owned entirely, as it is of EASI and ECO-REZ, where Conant was one of several shareholders. Conant incorporated CAN DO to engage in dredging and earth-moving work in order to limit his personal liability in these high-risk activities. Conant testified that the dredging work he did during the years in issue was done through CAN DO. Conant's personal involvement in these activities through CAN DO does not cause these activities to become Conant's trades or businesses, rather than CAN DO's trades or businesses. Respondent has conceded on brief that Conant was an employee and officer of EASI, CAN DO, and ECO-REZ. However, petitioners did not report any income--whether by way of salary, bonus, or commission--from these positions. We conclude that Conant's efforts with regard to these corporations were directed toward making the corporations prosper so that his investments would be profitable.

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[18] Section 162(a) provides, in relevant part, as follows:

SEC. 162. TRADE OR BUSINESS EXPENSES.
(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

Secondly, there does not appear to be any meaningful continuity in Conant's role as a dredge/equipment operator or lessor, compost plant disassembler, or inventor. As we found, supra, Conant leased his dredge only once and that was in 1973. In 1974, Conant assisted Trussell in moving equipment from his compost plant. Not until 1975 do we have any further evidence that, in fact, Conant leased some of his equipment. We have found that Conant handled the disassembling and the shipping of a compost plant in 1975. However, we have no indication that Conant disassembled a compost plant before 1975 or thereafter.

Finally, we have found, supra, that in the late 1960's, Conant started building an 8-inch dredge. However, we have no indication as to what Conant invented before, during, or after the years in issue. We have found, supra, that Conant had a shop in his home in which he was developing (1) an improved cutter head for a dredge and (2) a bomb shelter. However, petitioners have not supplied us with a time frame for these activities. In conclusion, we believe continuity[19] generally requires more than such isolated activity for each of the claimed trades or businesses. Industrial Research Products, Inc. v. Commissioner, 40 T.C. 578, 589 (1963).

Thirdly, although we recognize that a taxpayer may be engaged in more than one trade or business (see Curphey v. Commissioner, 73 T.C. 766, 775-776 (1980)), we are convinced that Conant sought his livelihood from his business as a Texaco consignee and not by operating or leasing dredge/equipment, disassembling compost plants, or inventing. We have no record of Conant ever receiving money from any of these alleged trades or businesses. Moreover, even where Conant contends that he was owed money from carrying on these alleged trades or businesses, Conant never sued to recover the money.

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[19] Petitioners cite Hazard v. Commissioner, 7 T.C. 372 (1946), as support for the proposition that "a taxpayer who rents out even a single piece of property is engaged in a trade or business." Petitioners have apparently overlooked the important point that the taxpayer in Hazard continuously rented the property for almost four years; thus distinguishing Hazard from the instant cases. The question is whether Conant's "activities were sufficiently systematic and continuous" (Curphey v. Commissioner, 73 T.C. 766, 775 (1980)) to place him in any of his contended-for trades or business. The answer is, "No".

We now consider the appropriate treatment of the claimed Schedule C business expenses in light of our conclusions that during the years in issue, Conant was in the trades or business of being a Texaco consignee, and a corporate officer and employee.

In disallowing a portion of the claimed Schedule C business expenses for 1974 and 1975, respondent has, in essence, divided these expenses into three categories: (1) those expenses paid on account of Conant's guarantee on a note, which respondent determined are nonbusiness bad debts entitled to short-term capital loss treatment; (2) those made on behalf of the three corporations, which respondent originally determined were also nonbusiness bad debts, entitled to short-term capital loss treatment;[20] and (3) those which respondent determined are personal or unverified.

We consider these categories of expenses, seriatim.

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[20] Respondent now asserts that these expenditures are contributions to the capital of the respective corporations. The effect of respondent's new assertion will be discussed infra.

A. Conant's Guarantee on a Note

Section 166(a)[21] allows deductions for worthless debts. However, under section 166(d)(1)[22] a nonbusiness bad debt is deductible by an individual only as a short-term capital loss.

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[21] SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

[The subsequent amendment of this provision by section 1906(b)(13) [sic] (A) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1834, does not affect the instant case.]

[22] SEC. 166. BAD DEBTS.

* * *

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

[The subsequent amendments of this provision by paragraphs (1)(A) and (2) of section 1402(b) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1731, 1732, and by subsections (b)(1) and (e) of section 1001 of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 1011-1012, do not affect the instant case.]

Under section 166(d)(2)[23] the debts to Conant are nonbusiness debts, unless they were acquired in connection with, or became worthless in, Conant's trades or businesses. Respondent's determination as to the amounts paid by Conant on account of Conant's guarantee on a note is presumed to be correct and petitioners bear the burden of proving otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

In order to prevail, petitioners must show a proximate relationship between the debt and Conant's trades or businesses as a Texaco consignee or corporate officer and employee.[24] Whipple v. Commissioner, 373 U.S. 193, 201 (1963); sec. 1.166-5(b), Income Tax Regs. The "proper measure [for such a relationship] is that of dominant motivation." United States v. Generes, 405 U.S. 93, 103-105 (1972); Shinefeld v. Commissioner, 65 T.C. 1092, 1096 (1976).

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[23] SEC. 166. BAD DEBTS.

* * *

(d) Nonbusiness Debts.--

* * *

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

[24] Petitioners do not contend they were in a separate trade or business of guaranteeing notes or of making loans.

For petitioners to treat the amounts paid to First Bank as business bad debts, petitioners must show that Conant's dominant motivation in guaranteeing the note for EASI was proximately related to (1) his business as a Texaco consignee or (2) his status as an officer and employee of EASI, rather than as an investor in EASI. United States v. Generes, supra; Benak v. Commissioner, 77 T.C. 1213 (1981); Shinefeld v. Commissioner, 65 T.C. at 1097-1099; Estate of Byers v. Commissioner, 57 T.C. 568, 577-578 (1972), affd. 472 F.2d 590 (CA6 1973). The parties agree that Conant operated his business as a Texaco consignee separately from his trade or business as a corporate officer and employee at EASI. We have no evidence that Conant's guarantee on a note for EASI was in any way related to his business as a Texaco consignee.

The fact that a loan or payment is made in furtherance of an employer's trade or business does not mean that it is proximately related to that of the officer-employee. Townshend v. United States, 384 F.2d 1008 (Ct. Cl. 1967). Benak v. Commissioner, supra; Shinefeld v. Commissioner, supra; Estate of Byers v. Commissioner, supra. Cf. Brenhouse v. Commissioner, 37 T.C. 326, 330 (1961), which involved members of a partnership.

On the record in the instant cases, petitioners have failed to prove that Conant's dominant motive in guaranteeing the note to First Bank was the protection or enhancement of his trade or business as an officer-employee of EASI, as distinct from the enhancement of his investment interest as shareholder in EASI.[25]

We conclude that petitioners have failed to carry their burden of proving that Conant's dominant motivation in guaranteeing a note to First Bank stemmed from his trades or businesses as a Texaco consignee, or as an EASI officer-employee rather than his role as an EASI investor.

Petitioners assert on opening brief, "that the holdings of Generes and Anderson[26] can be extended to other areas dealing with dual status taxpayers (shareholder--non-business status and business status) and a business bad debt should be allowed where the dominant purpose of the loan was connected with the business status of the taxpayer." In support of their position, petitioners cite six cases[27] where the courts have allowed bad debt deductions for loans to corporations. However, all of these cases are factually distinguishable from the instant cases; also, all were decided before the Supreme Court set forth the standard of "dominant motivation" in Generes.

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[25] Indeed, on brief, petitioners state that "it is not claimed that the loans made by the Petitioner were to protect an employment status".

[26] In Anderson v. United States, 555 F.2d 236 (CA9 1977), the Court of Appeals affirmed, as not clearly erroneous, a lower court's conclusion that the dominant motive for Anderson's loan to a corporation was to protect his job.

[27] Lundgren v. Commissioner, 376 F.2d 623 (CA9 1967), revg. T.C. Memo. 1965-314; Estate of Saperstein v. Commissioner, T.C. Memo. 1970-209; Morrow v. Commissioner, T.C. Memo. 1965-45; Rubin v. Commissioner, T.C. Memo. 1963-218; Wade v. Commissioner, T.C. Memo. 1963-50; and Schafer v. United States, unreported opinion (W.D. Okla. 1968, 21 AFTR 2d 1087, 68-1 USTC par. 9306).

On answering brief, petitioners attempt to distinguish Generes on the basis that Conant, unlike the taxpayer in Generes, had no family relationship with any director, officer, or shareholder in EASI. This difference is not significant in light of petitioners' failure to establish that Conant was engaged in any trade or business to which the debts were proximately related.

For the first time, on brief, petitioners assert "that should the court fail to find these various expenses deductible to the Petitioner under §§162, 212 or 166 of the Code, that the Court should find that such necessary and ordinary expenses (as stipulated by the Respondent) are deductible as losses under §165 to the Petitioner as an individual, as they are losses to Petitioner in his trade(s) or business(es)." (Emphasis added.)

A basic problem with this position is that we have already concluded that none of Conant's trades or businesses generated the guarantee, the payments, or the debt that became worthless.

A second difficulty with petitioners' position, as applied to their losses on account of Conant's guarantee of the EASI note, is that deductibility of bad debts is governed by section 166. A loss on a guarantee is not deductible under section 165, even if the loss is also not deductible because it fails to meet one or another of the requirements of section 166. Hynes v. Commissioner, 74 T.C. 1266, 1286-1287 (1980).

Finally, we note that, in his opening statement at trial, respondent's counsel set forth his understanding that both sides concurred that section 165 was not applicable to the instant case. Petitioners' counsel did not dispute the correctness of this statement at that point, nor at any point until he raised this "inapplicable" issue on brief.

We hold for respondent on this issue.

B. Expenditures on Behalf of the Three Corporations

At trial, respondent asserted that the portion of the claimed Schedule C business expenses for 1974 and 1975 that he determined were expenditures made on behalf of EASI, CAN DO, or ECO-REZ and deductible as nonbusiness bad debts, should instead be treated as contributions to capital of the respective corporation "and when the corporation goes defunct, which are not at [sic] the years at issue, except in the case of CAN DO then they would be available for non-business bad debts and short-term capital losses."[28] Petitioners contend that the expenditures are deductible under section 162 or 212. The question of whether the expenditures are debts, contributions to capital, or Conant's business or income-seeking expenses is one of fact. See, e.g., Dorminey v. Commissioner, 26 T.C. 940, 946 (1956). In the usual case, petitioners would bear the burden of proof entirely. However, respondent's assertion as to capital contributions constitutes a "new matter", as to which he bears the burden of proof. Compare Estate of Emerson v. Commissioner, 67 T.C. 612, 620 (1977), with Florists' Transworld Delivery Assn. v. Commissioner, 67 T.C. 333, 348 (1976); see Rule 142(a).

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[28] We are unclear as to respondent's rationale in concluding that the contributions to capital would ultimately be deductible as short-term capital losses, since the relevant holding periods appear to be longer than 6 months and a contribution to capital is not a debt which may become worthless. On this point (as on a number of points) the parties' delineations of their positions leave us with significant uncertainties.

We agree with respondent's current position that (contrary to respondent's original determination) Conant's expenditures are not loans to the corporations giving rise to short-term capital losses under section 166(d), that (contrary to petitioners' position) Conant's expeditures are not currently deductible expenses under section 162 or 212, but that Conant's expenditures are contributions to capital of the respective corporations.

1. Capital Contributions v. Loans

First, we consider whether Conant's expenditures were loans or capital contributions to EASI, CAN DO, and ECO-REZ. This is an issue which has often been before the courts. In Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493-494 (1980), we commented as follows:

> In resolving similar questions of debt versus equity, courts have identified and considered various factors. See, e.g., Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970) (11 factors); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (16 factors); [21] Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790 (1975) (13 factors). Among the factors which have been considered are: the names given to the certificates evidencing the indebtedness; presence or absence of a fixed

> maturity date; source of payments; right to enforce payments; participation in management as a result of the advances; status of the advances in relation to regular corporate creditors; intent of the parties; identity of interest between creditor and stockholder; "thinness" of capital structure in relation to debt; ability of corporation to obtain credit from outside sources; use to which advances were put; failure of debtor to repay; and risk involved in making advances.
>
> The identified factors are not equally significant (*Estate of Mixon v. United States*, *supra* at 402), nor is any single factor determinative. *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946). Moreover, due to the myriad factual circumstances under which debt-equity questions can arise, all of the factors are not relevant to each case. The "real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice." *Estate of Mixon v. United States*, *supra* at 403. "The various factors * * * are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." *Fin Hay Realty Co. v. United States*, *supra* at 697. As expressed by this Court, the ultimate question is "Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).
>
> [21] See *Astleford v. Commissioner*, T.C. Memo. 1974-184, *affd. per curiam* 516 F.2d 1394 (8th Cir. 1975); *Diamond Bros. Co. v. Commissioner*, T.C. Memo. 1962-132, *affd.* 322 F.2d 725 (3d Cir. 1963).

In the instant cases, there is not a written document which would create in Conant an unconditional right to demand payment. There are no papers or other formal indicia evidencing the arrangement between Conant and either EASI, CAN DO, or ECO-REZ. Thus there are no provisions for interest, no enforceable obligation on any of the corporations to repay Conant for the amount of his expenditures, no maturity date, no provision for prepayment by the corporations, and no provision for superiority of lien on the respective corporations' assets. It is clear that Conant and the corporations failed to follow any formality with regard to the expenditures. There was no corporate action authorizing the "borrowing", Conant did not take any security as a result of the expenditures, and there was no provision made for a sinking fund or corporate reserve to effect repayment. No repayment of the alleged debts was ever made. No interest was ever paid. No law suits were filed to attempt to recover any portion of the alleged debts and the record contains no evidence that a formal demand for repayment was ever made. In short, Conant failed to act like a creditor. Instead, by tolerating nonpayment of principal, Conant evidenced an attitude of placing his shareholder interests ahead of his creditor interests in order to advance the needs of the corporations. Thus, since Conant treated these expenditures the way equity investments are normally treated, we will consider these expenditures to be equity, and not loans.

2. Capital Contributions v. Sec. 162

Next we consider whether the expenses are currently deductible under section 162 or 212, or whether they are to be treated as capital contributions.

We have already found, supra, that the expenditures made by Conant on behalf of EASI, CAN DO, and ECO-REZ were not related to Conant's business as a Texaco consignee. It is well established that absent a binding obligation, a taxpayer generally may not deduct expenses incurred for the benefit of another. Deputy v. du Pont, 308 U.S. 488, 493 (1940); Westerman v. Commissioner, 55 T.C. 478, 482 (1970). Thus, corporate officers, employees, and shareholders who voluntarily incur corporate expenses are not entitled to a deduction for these expenditures because they are not considered necessary employee expenses. Westerman v. Commissioner, supra. The reason for this rule is explained in Noland v. Commissioner, 269 F.2d 108, 111 (CA4 1959) as follows:

> The business of a corporation, however, is not that of its officers, employees, or stockholders. Though the individual stockholder-executive, in his own mind, may identify his interest and business with those of the corporation, they legally are distinct, and, ordinarily, if he voluntarily pays or guarantees the corporation's obligations, his expense may not be deducted on his personal return. * * *

On the other hand, where, as a condition of his employment, an employee incurs unreimbursed expenses on behalf of his employer, the employee may deduct those expenses which are ordinary and necessary to his business as an employee, to the extent they are not subject to reimbursement. Walliser v. Commissioner, 72 T.C. 433, 437 (1979).

Conant in his capacity as officer and employee in EASI, CAN DO, and ECO-REZ was not required to pay the expenditures on behalf of the corporations. Conant voluntarily made the expenditures and the expenditures are not deductible by petitioners.

Conant's attempt to sell chemicals to Allied Polymer was an activity directly related to his business as a Texaco consignee. The expenses of this activity are deductible under section 162.

Petitioners have the burden of proving that their deductions are greater than the amount determined by respondent. In Cohan v. Commissioner, 39 F.2d 540 (CA2 1930), it was held that when the Court was convinced that some expenses were paid or incurred, then some amount should be allowed even though the taxpayer has not shown the precise amount that should be allowed. In the instant case, it is obvious that Conant incurred some expenses in his business as a Texaco consignee. However, respondent has determined that some deductions should be allowed (see tables 1, 2, and 3, supra). Petitioners have not shown that they should be entitled to any greater deductions than those already allowed by respondent.

Petitioners maintain that the expenditures made on behalf of EASI and ECO-REZ should be deductible because they were made under duress and pursuant to his duty as a retired United States Army officer. Petitioners assert that Conant's "involvement with the corporations EASI and EcoRez [sic] was in an attempt by him to maintain contact with * * * various individuals and corporations so that he might secure information vital to his country's safety." An individual's concerns about the safety of this Nation are commendable. However, we fail to see how such concerns would convert the expenditures in issue into deductions.

We conclude that petitioners are not entitled to deductions under section 162 for any greater amounts than respondent has already allowed.

3. Capital Contributions v. Sec. 212

Section 212[29] allows deductions for expenses with respect to an income-producing activity or property held for the production of income. The test of deductibility under section 212(1) and (2) is similar to that under section 162 with the exception that the expense need not be incurred in a trade or business. See, e.g., Rodney v. Commissioner, 53 T.C. 287, 320 (1969).

As we pointed out in Deely v. Commissioner, 73 T.C. 1081, 1097-1098 (1980)--

> [B]efore petitioner is entitled to the benefits of section 212, he must overcome two hurdles: Petitioner must show that the expenses claimed are indeed his and not those of a separate and distinct taxpayer (Deputy v. Du Pont, [308 U.S. 488, 494 (1940)]; Kaplan v. Commissioner, 21 T.C. 134 (1953)), and the expenses claimed must be ordinary and necessary and bear a reasonable and proximate relation to the production or collection of income. Sec. 1.212-1(d), Income Tax Regs.; Kinney v. Commissioner, 66 T.C. 122 (1976).

Conant's expenditures on behalf of EASI, CAN DO, and ECO-REZ, were just that--expenditures on behalf of another. Petitioners are no more entitled to deduct such expenditures under section 212 than they are under section 162.

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[29] Section 212 provides, in relevant part, as follows:

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; * * *

Respondent concedes that Conant's expenditures on behalf of EASI, CAN DO, and ECO-REZ may be treated as contributions to the capital of the respective corporations. We so hold.

C. Personal or Unverified Expenses

Deductions are allowable under section 162 for the taxpayer's ordinary and necessary expenses in carrying on a trade or business. However, because of section 262,[30] personal expenses generally are not deductible. Sharon v. Commissioner, 66 T.C. 515, 522-525 (1976), affd. 591 F.2d 1273, 1275 (CA9 1978).

Under section 6001[31] and section 1.6001-1(a) and (e), Income Tax Regs., a taxpayer must keep such permanent books of accounts or records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on his tax return.

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[30] SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter [i.e., chapter 1], no deduction shall be allowed for personal, living, or family expenses.

[31] SEC. 6001. NOTICE OR REGULATIONS REQUIRING RECORDS, STATEMENT, AND SPECIAL RETURNS.

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title. * * *

[The subsequent amendment of this provision by section 1906(b)(13) [sic] (A) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1834, does not affect the instant case.]

At trial, Conant admitted that some of the claimed expenses for the years in dispute, were personal items. Furthermore, Conant's testimony as to some of the other items is confusing. Petitioners presented no documentation at trial to substantiate their claimed deductions. Conant's uncorroborated and self-serving testimony is insufficient to overcome respondent's presumption of correctness on this issue.

Petitioners assert for the first time, on opening brief, justification for some of the disallowed deductions for salary, rent, and station expenses in 1974. Mere statements on brief do not constitute evidence. Evans v. Commissioner, 48 T.C. 704, 709 (1967), affd. 413 F.2d 1047 (CA9 1969); Rule 143(a).

Petitioners had the burden of proving respondent's determinations to be in error and they have failed completely to do so.

We hold for respondent on this issue.

We summarize our holdings with respect to the Schedule C business expenses for 1974 and 1975 as follows: (1) petitioners are entitled to nonbusiness bad debt deductions for 1974 and 1975 in the amounts of Conant's payments in the respective years on account of his guarantee of EASI's note, (2) petitioners must capitalize Conant's other expenditures on behalf of EASI, CAN DO, and ECO-REZ, and (3) petitioners have failed to show that they are entitled to deduct or capitalize any of the Schedule C items that respondent disallowed as personal or unverified.

II. Schedule C Business Expenses--1976

Respondent maintains that the amounts claimed on petitioners' 1976 tax return "as returns and allowances of $3,987.40 are not deductible in the tax year 1976 because it has not been established that these are [petitioners'] expenses." Respondent further contends that $35,815.89 of the deductions "shown as business expenses * * * [on the Schedule C are nondeductible] because it has not been established that * * * [they were] for ordinary and necessary business expenses or [were] expended for the purposes designated." Petitioners maintain that the $3,987.40 garnished from Conant's commission checks from Texaco is deductible under section 166 as a business bad debt. Petitioners further assert that the other disallowed Schedule C business expenses are deductible under section 162, section 212, or section 165.

We agree in part with each side.

Petitioners have the burden of proving respondent's determinations to be in error. Welch v. Helvering, supra; Rule 142(a). We have already found, supra, that Conant's attempt to provide Allied Polymer with certain chemicals was an activity of Conant's business as a Texaco consignee. Incorporating herein our earlier analysis of the requirements to establish a business bad debt under section 166 (part I. A., supra), we are convinced that Conant's primary motivation in guaranteeing the note for ECO-REZ was proximately related to his business as a Texaco consignee. Conant intended to sell the chemicals to Allied Polymer through his business as a Texaco consignee. Conant expected to receive a minimum of $10,000 in commission from such sales. When Conant returned from Ireland, he arranged for ECO-REZ to assist Allied Polymer with its financial difficulties. His guarantee on the $72,000 note for ECO-REZ was motivated by his interest in earning additional commission from his sales of Texaco products. The $3,987.40 garnished from Conant's commission checks from Texaco was a business bad debt.

To receive a deduction, the business bad debt must, however, be shown to be totally worthless in the year for which it is claimed. (Sec. 166(d)(1)(A).)[32] The debt arose from a pre-existing enforceable obligation. The record contains little information on the financial situation of ECO-REZ from 1974 through 1976. ECO-REZ did not make any payments on the note. Upon ECO-REZ's failure to pay, the Citizens Bank sued Conant as guarantor. The Citizens Bank garnished $3,987.40 from Conant's commission checks from Texaco. While the matter is not free from doubt, we conclude that the business bad debt became worthless in 1976, when the garnishment was made.

We hold for petitioners on this issue.

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[32] Petitioners do not claim a deduction for any part of the $3,987.40 on account of partial worthlessness, under section 166(a)(2).

As to the remaining disallowed Schedule C business expenses for 1976, petitioners have, in general, failed to carry their burden of proof. However, in part I. B. of this opinion, supra, we held that Conant's 1974 and 1975 expenditures on behalf of EASI, CAN DO, and ECO-REZ should be treated as contributions to the capital of the respective corporations. We conclude that the same analysis is applicable to Conant's 1976 expenditures on behalf of the corporations.

We hold that (1) petitioners are entitled to a business bad debt deduction of $3,987.40, (2) petitioners must capitalize Conant's other expenditures on behalf of EASI, CAN DO, and ECO-REZ,[33] and (3) petitioners have failed to show that they are entitled to deduct or capitalize any of the Schedule C items that respondent disallowed as personal or unverified.

III. Dividend Income--1976

Respondent maintains that during 1976, petitioners received dividend income from petitioners' wholly-owned business, Santa Fe Fuels, Inc., in the amount of $1,690.93. Respondent asserts that Santa Fe Fuels, Inc., paid various personal expenses for petitioners. Petitioners made no reference to respondent's adjustment for dividend income on petition, at trial, or on opening brief. We need not decide whether petitioners' silence constitutes a concession because the matter is resolvable on burden of proof grounds.

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[33] We have found that CAN DO was dissolved in 1976. Petitioners did not claim a deduction on account of this dissolution; respondent has not claimed that Conant had a gain on account of this dissolution. We hold that petitioners realized a 1976 long-term capital loss in the amount of Conant's contributions to CAN DO in 1974, 1975, and 1976.

Respondent's determination as to matters of fact in the notice of deficiency "has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong." Welch v. Helvering, 290 U.S. at 115; Rule 142(a). Petitioners have failed to introduce any evidence on the issue of dividend income.

On answering brief, petitioners assert that while respondent's notice of deficiency is granted presumptive status, it "is not competent evidence of the truth of the matters asserted within itself." Petitioners state that "[r]espondent has brought forth no evidence to support his contention of a constructive dividend, thus the omission of such evidence, shown by Petitioner's [sic] advancing of Respondent's agent's workpapers, establishes * * * that Petitioner [sic] should prevail on this issue." Petitioners' view of the situation is clearly erroneous. Petitioners apparently have failed to comprehend the fact that they have the burden of proof on this issue. Petitioners have failed to carry their burden of proof.

We hold for respondent on this issue.

IV. Section 6653(a)--Negligence, Etc.

Respondent contends that petitioners are liable for an addition to tax under section 6653(a) for each of the years in issue because of "the total absence of any proper recordkeeping or proper documentation of the claimed responses by the petitioners." Petitioners maintain that respondent's audit of their 1973 return resulted in their owing a nominal amount of additional taxes. In reliance on the results of this audit, petitioners assert that they "believed that the expenses here at issue were of such a nature as to allow deduction. * * * [Accordingly] he had an honest misunderstanding or difference of opinion as to the deductibility of the items contested for the years at issue, based on the actions of the Respondent in the audit for 1973, the year immediately preceeding the years at issue of 1974, 1976 [sic] and 1976."

An addition to tax under section 6653(a)[34] is imposed if any part of any underpayment of tax is due to negligence or intentional disregard of rules or regulations. Petitioners have the burden of proving error in respondent's determinations that this addition to tax should be imposed against them. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972).

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[34] SEC. 6653. FAILURE TO PAY TAX.

(a) Negligence or Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.--If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

[The subsequent amendments of this provision (by sec. 101(f)(8) of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, 94 Stat. 229, 253, by sec. 722(b)(1) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 342, and by sec. 107(a)(3) of the Technical Corrections Act of 1982, Pub. L. 97-448, 96 Stat. 2365, 2391) do not affect the instant case.]

As we explained, supra (issue I. C.), under section 6001 and section 1.6001-1(a) and (e), Income Tax Regs., a taxpayer must keep permanent books of account or records to establish the amount of gross income, deductions, credits, or other matters required to be shown on their tax return.

When Conant left the IRS, he was chief of an audit section; albeit in the 1930's, we have no doubt that in his position he realized the importance of maintaining books of account or records. Petitioners' failure to keep the records necessary to substantiate some of their claimed deductions for 1974, 1975, and 1976--a failure which petitioners have not adequately explained--indicates that petitioners were negligent. Not only have petitioners failed to prove error by respondent in this matter, but the record supports the conclusion that petitioners were negligent.

In responding to petitioners' assertions, we note that we have insufficient facts from the 1973 audit to agree with petitioners. Petitioners, having the burden of proof, should have introduced evidence as to the specific expenses claimed on their 1973 return and the corresponding adjustments. We have no indication whether the same types of expenses (whether or not in similar amounts) were claimed on this return. The fact that it was determined that petitioners owed only $184 in additional taxes does not carry the burden for petitioners. On the contrary, it indicates that petitioners' 1973 tax return did not properly represent their activities for 1973.

We hold for respondent on this issue.

Decisions will be entered

under Rule 155.

JU 11.7/2: 1986-416

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T. C. Memo. 1986-416

UNITED STATES TAX COURT

CONNIE BAKER McCLENDON, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13286-84. Filed September 4, 1986.

Connie Baker McClendon, pro se.

Nancy W. Hale, for the respondent.

MEMORANDUM OPINION

GUSSIS, Special Trial Judge: This case was assigned to Special Trial Judge James M. Gussis pursuant to section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180, 181 and 182 of the Tax Court Rules of Practice and Procedure.[1]

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all Rule references are to the Tax Court Rules of Practice and Procedure.

G.M/VL

Respondent determined a deficiency in petitioner's Federal income tax for 1981 in the amount of $293.60. After concessions by both parties, the remaining issues are (1) whether petitioner is entitled to a deduction for legal fees in the amount of $600; (2) whether petitioner is entitled to a casualty loss deduction under section 165(c)(3) in 1981 in the amount of $300, and (3) whether petitioner is entitled to a deduction for a tax of $54 paid with respect to her telephone and a tax of $36 on utilities.

Some of the facts have been stipulated and are found accordingly. Petitioner resided in Knoxville, Tennessee at the time the petition herein was filed.

Petitioner claimed a deduction for legal fees in 1981 in the amount of $600 which was disallowed by respondent. Petitioner has the burden of proof on this issue. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner incurred these expenditures in connection with her efforts to obtain child support and, in addition, to regain possession of her personal automobile from a dealer. Section 262 expressly disallows deductions for expenditures that are personal in nature. Here, the character of both claims pursued by petitioner was unquestionably personal in nature and consequently the legal fees incurred must also be categorized as personal expenditures. United States v. Gilmore, 372 U.S. 39 (1963). We must therefore conclude that petitioner is not entitled to a deduction for the legal expenses incurred by her in 1981.

Petitioner claimed a casualty loss deduction in 1981 in the amount of $300 which was disallowed by respondent. Section 165(c)(3) allows a deduction for losses of property arising from "fire, storm, shipwreck, or other casualty." The term "other casualty" has been interpreted to mean an accident, a mishap or some sudden invasion by a hostile agency. Maher v. Commissioner, 76 T.C. 593, 596 (1981), affd. 680 F.2d 91 (11th Cir. 1982). Petitioner's deduction represents payments to a car rental agency during the period that her personal automobile was unavailable due to mechanical difficulties. These factual circumstances simply do not fit within the accepted definition of a casualty loss. We conclude therefore that petitioner is not entitled to a casualty loss deduction in any amount in 1981 under the provisions of section 165(c)(3).

Petitioner claimed a deduction in 1981 of $54 for a telephone tax and $36 for a utilities tax. Respondent disallowed both deductions. It appears that the telephone tax was a Federal excise tax. Section 164(a) provides for several classifications of taxes that shall be allowed as a deduction. Federal excise taxes are not among such classifications. See section 1.164-2(f), Income Tax Regs. Nor has petitioner met her burden of showing that the utilities tax of $36 falls within one of the allowable classifications of deductble taxes. Nor has petitioner shown that she is entitled to deduct either of these amounts as additional sales taxes since the record shows that she was allowed a general sales tax deduction based upon the amount allowable under the optional sales tax deduction tables. Petitioner's choice of using the optional tables precludes the separate deduction of the taxes here in dispute, even if they were otherwise deductible. Respondent is sustained on this issue.

Decision will be entered
under Rule 155.

JU 11.7/2: 1986-417

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T. C. Memo. 1986-417

UNITED STATES TAX COURT

DAVID E. WASSERSTROM and SANDRA R. WASSERSTROM, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15943-81. Filed September 4, 1986.

P, a tax attorney, deducted his distributive share of 1977 losses of two partnerships both formed for the purpose of mining coal on leased property. The partnership losses resulted from claimed deductions for advanced royalty payments to third parties. The advanced royalties were paid in part by cash and in part by partnership notes. Payment of the partnership notes depended upon the partnership's "available cash." No coal was ever mined by or on behalf of either partnership.

As a result of an office audit involving substantiation of medical and charitable deductions, P signed a Form 1902-E (Report of Individual Audit Change) and paid a $42 tax deficiency for 1977. Subsequently, respondent disallowed deductions claimed by P with respect to his distributive share of 1977 partnership losses.

Held: (1) Form 1902-E is not a final closing agreement within the meaning of section 7121, I.R.C. 1954; (2) the partnerships were structured to generate substantial tax benefits and neither was formed with an objective of entering into coal mining activities for profit; thus P's claimed 1977 deductions for his

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distributive share of partnership losses are disallowed; Section 1.612-3(b)(3), Income Tax Regs., valid; and (3) Respondent's imposition of addition to tax for negligence sustained.

Joseph E. Lundy and Gerhart L. Klein, for the petitioners.

David E. Gaston and Kenneth J. Rubin, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: By notice of deficiency dated April 6, 1981, respondent determined a deficiency in petitioners' 1977 Federal income tax in the amount of $250,487, and an addition to the tax pursuant to section 6653(a)[1] in the amount of $12,524.

Petitioners attack the validity of the notice of deficiency, contending that respondent is barred from assessing additional tax liabilities because petitioner David E. Wasserstrom signed a Form 1902-E (Report of Individual Income Tax Audit Changes) with respect to 1977 on February 2, 1979. Thus, before deciding the substantive issues, we must decide whether Form 1902-E is a final closing agreement within the meaning of section 7121. In the event we determine that Form 1902-E is not a final closing agreement, then both parties have made certain concessions. After concessions, the remaining substantive issues are: (1) whether petitioners are entitled to deduct their distributive share of losses from the coal mining activities of two limited partnerships, Campbell Hollow Associates, II, Ltd. and North Fork Associates; and (2) whether petitioners are liable for an addition to tax pursuant to section 6653(a).[2]

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulation of facts and attached exhibits are incorporated herein by this reference.

David E. Wasserstrom and Sandra R. Wasserstrom, husband and wife, resided in Melrose Park, Pennsylvania at the time they filed their petition. Sandra Wasserstrom is a party in this case solely because she filed a joint return with her husband for 1977; therefore David Wasserstrom will be referred to as petitioner.

Petitioner is an attorney concentrating in taxation and business related matters. He received a Masters of Law Degree in taxation and was a law clerk for one of the judges on this Court from 1963 to 1964. He has prepared numerous private offering memoranda for partnerships engaged in coal tax shelters,[3] including the private offering memoranda for the two limited partnerships involved herein.

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[2] Resolution of the substantive issues impacts the amount of petitioners' deductions for medical expenses and sales taxes.

[3] See Weinstein v. Commissioner, T.C. Memo 1986-376.

Campbell Hollow Associates II, Ltd.

Campbell Hollow Associates II, Ltd. (CHA) is a Florida limited partnership formed on December 28, 1977, for the purpose of mining coal on leased land located in Whitley County, Kentucky. The sole general partner was Richard D. Kaplan.[4]

During 1977, petitioner and Morris L. Chucas were equal partners in Elliott H. Lewis Associates ("Lewis Associates").[5] On December 28, 1977, Lewis Associates contributed $150,000 to CHA[6] and became a 25.62 percent limited partner therein; accordingly, petitioner had a 12.81 percent indirect interest in CHA.

On December 30, 1977, CHA obtained from Williamsburg Associates (Williamsburg), a Florida general partnership, the right to mine and remove all mineable and merchantable coal from three tracts of land in Whitley County, Kentucky (the Campbell Hollow site) pursuant to a lease for a basic term of 20 years.[7] Under the lease, CHA agreed to pay Williamsburg a royalty of

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[4] Kaplan had no prior coal mining experience.

[5] Petitioner and Morris L. Chucas were former law partners. They formed Elliot H. Lewis, a general partnership, in 1976 for the purpose of making investments outside their law practice. The name "Elliott H. Lewis" is derived by a combination of the respective middle names of David Elliott Wasserstrom (petitioner) and Morris Lewis Chucas.

[6] Pursuant to a private offering of limited partnership interests, CHA raised $576,000; Richard Kaplan, as general partner, contributed an additional $1,000, making the total capital contribution to CHA $577,000.

[7] Two days prior to entering into the lease (i.e., December 28, 1977) Williamsburg Associates had purchased the Campbell Hollow site for $200,000.

$2.50 per ton for all coal mined and sold and a minimum annual royalty of $153,866 during the term of the lease. The minimum annual royalty for the first 15 years (i.e., $2,308,000)[8] was payable in advance as follows: $496,800 in cash and a note for the $1,811,200 balance. The note bore interest at the rate of six percent per annum and was to mature on December 31, 1992. Payment of the note was dependent upon CHA's "available cash", i.e., cash remaining after CHA paid "all normal and ordinary" expenses other than payment on the note and distributions to its partners. The note was described as "fully recourse" as to both CHA and all its partners except that it became nonrecourse (secured only by the assets of CHA) if: (1) CHA's average tonnage of coal mined and sold for any consecutive three year period was less than 55,000 tons; or (2) the principal balance of the note was reduced to $1 million by December 31, 1987.

On December 30, 1977, CHA entered into (1) a mining contract with Medlin Coal Company[9] under which Medlin would operate a coal mine on the Campbell Hollow site and receive $16 per ton for all coal mined and sold, and (2) a sales agreement with London

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[8] The tonnage royalties otherwise due ($2.50 per ton) were to be credited against the annual minimum royalty ($153,866). To generate $153,866 in royalties, 61,546 tons of coal would have to be mined each year from the Campbell Hollow site, and over the term of the lease (25 years) 1,538,650 tons would have to be mined in order to recoup the advanced minimum royalty ($2,308,004). The total amount of recoverable coal from the Campbell Hollow site was estimated by CHA's mining engineer (Mr. Yeloushan) to be 1,620,000 tons.

[9] The principals of Medlin Coal Company were the same individuals as the principals of Williamsburg.

Brokerage Company to sell the coal mined at the Campbell Hollow site at a fixed price of $20.75 per ton until 1983, and $20.88 thereafter.

The Campbell Hollow site had never previously been mined; no core samples to indicate the existence (and amount) of coal on the site were taken, and no mining permits were obtained. No coal was mined on the Campbell Hollow site by Medlin or by CHA, and CHA made no payments on its note to Williamburg.

The $577,000 CHA received as capital contributions was used as follows:

Payee	Amount	Purpose
Williamsburg	$496,800	advanced minimum royalty
David E. Wasserstrom	32,000	legal fees
Richard Kaplan	40,000	management fee
	$568,800	
	8,200	working capital
TOTAL	$577,000	

In its 1977 return, CHA reported a loss of $2,377,955, including the advanced royalty payment of $2,308,000; petitioner through his interest in Lewis Associates, deducted $304,616 as his distributive share of the partnership's 1977 loss, which deduction respondent disallowed.

North Fork Associates

Petitioner contributed, as a limited partner, $11,250 to the capital of North Fork Associates (North Fork), a New Jersey limited partnership formed on December 27, 1977, for the purpose of mining coal on subleased land located in Perry County, Kentucky.[10] North Fork's sole general partner was Barry Wasserstrom.[11]

On December 29, 1977, North Fork obtained from Partridge Coal Company, a Kentucky corporation (Partridge), the right to mine and remove all mineable and merchantable coal from two tracts of land located in Perry County, Kentucky (the Boggs property), pursuant to a sublease for a basic term of 20 years. Under the sublease, North Fork agreed to pay Partridge a royalty equal to 12.5 percent of the gross selling price of all coal mined and sold and a minimum annual royalty of $125,000 during the term of the sublease. The minimum annual royalty for the first 14 years (i.e., $1,750,000[12]) was payable in advance as

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[10] Pursuant to a private offering of limited partnership interests, North Fork raised $525,000.

[11] Barry Wasserstrom, petitioner's cousin, had minimal prior coal mining experience. He contributed $1,000 to North Fork, making $526,000 the total capital contribution to North Fork. See footnote 10.

[12] The percentage royalties otherwise due (12.5 percent of the gross selling price of all coal mined and sold) were to be credited against the annual minimum royalty ($125,000). To generate $125,000 in royalties, 40,000 tons of coal would have to be mined from the Bogg property and sold for $25 per ton (the spot market price of coal in December, 1977) each year, and over the term of the lease (20 years) 800,000 tons of coal would have to be mined in order to recoup the advanced minimum royalty
(footnote continued)

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follows: $500,000 in cash and a note for the $1,250,000 balance. The note bore interest at the rate of six percent per annum and was to mature on December 31, 1989. Payment was dependent on North Fork's "available cash", i.e., cash remaining after North Fork paid "all normal and ordinary" expenses other than payment on the note and distribution to its partners. The note was described as "fully recourse" as to both North Fork and all its partners except that it became nonrecourse (secured only by the assets of North Fork) if: (1) North Fork's average tonnage of coal mined and sold for any consecutive three year period was less than 30,000 tons; or (2) the principal balance of the note was reduced to $750,000 by December 31, 1983.

On December 29, 1977, North Fork entered into a contract with Partridge Mining Company, a Kentucky corporation, (Partridge Mining)[13] to mine coal on the Boggs property at a price of 75 percent of the gross selling price (excluding commissions) of all coal mined and sold.

No coal was mined by Partridge Mining or North Fork on the Boggs property, and North Fork made no payments on its note to Partridge.

The $526,000 NFA received as capital contributions was used as follows:

(footnote continued from previous page) ($1,750,000). The total amount of recoverable coal from the Bogg property was estimated by North Fork's mining engineer (Mr. Ham) to be 1,044,500 tons.

[13] Robert D. Powell was the president and a stockholder of both Partridge and Partridge Mining.

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Payee	Amount	Purpose
Partridge	$500,000	advanced minimum royalty
David E. Wasserstrom	17,500	legal fees
Barry Wasserstrom	6,000	management fee
	$523,500	
	2,500	working capital
TOTAL	$526,000	

In its 1977 return, North Fork reported a loss of $1,773,500, including the advanced royalty payment of $1,750,000; petitioner deducted $37,244 as his distributive share of the partnership's 1977 loss, which deduction respondent disallowed.

Procedural Issue

As a result of an office audit involving substantiation of medical and charitable deductions claimed in 1977, petitioner agreed to certain adjustments resulting in a $42 tax increase. At the time of the audit (February 2, 1979), petitioner signed respondent's Form 1902-E, entitled "Report of Individual Tax Audit Changes." The form contained the following language:

> Although this report is subject to review, you may consider it as your written notice that your case is closed if you are not notified of an exception to these findings within 30 days after a signed copy of this report or a signed waiver, Form 870, is received by the District Director. If you agree, please sign one copy and return it in the enclosed return envelope. Keep the other copy with your records.

Petitioner's wife, who was not present at the meeting with respondent's agent, did not sign the form, nor did the auditing agent. Several months thereafter, petitioner received a bill from the Internal Revenue Service for $42, plus interest, which he promptly paid.

Subsequently, respondent questioned the deductions claimed by petitioner with respect to his share of losses from various partnerships, including CHA and North Fork. In November, 1980, respondent sent petitioner a Form 872, entitled "Consent to Extend the Time to Assess Tax," and requested petitioner to agree to an extension of the period of limitations on assessment for 1977. Petitioner did not sign the Form 872; respondent therefore issued, on April 6, 1981, the notice of deficiency involved herein.

Respondent contends that petitioner is not entitled to deduct any amount as his distributive share of CHA's or North Fork's losses because neither partnership engaged in coal mining activities for profit. Even if the partnerships had bona fide profit motives, respondent claims that: (a) pursuant to section 1.612-3(b)(3), Income Tax Regs., deductions are not allowable with respect to the advanced minimum royalty payments, and (b) the notes for those royalty payments were not bona fide obligations.

Petitioner argues that respondent was precluded from determining a deficiency for 1977 by application of the terms contained in Form 1902-E.[14] Even if the notice of deficiency was validly issued, claims petitioner, he is entitled to deduct his share of partnership losses because the partnerships engaged in coal mining activities for profit. Section 1.612-3(b)(3), Income Tax Regs., according to petitioner, was invalidly amended; under the regulation prior to amendment, the partnerships' advanced minimum royalties were deductible. Finally, claims petitioner, the partnership notes were bona fide.

OPINION

Procedural Issue

Section 7121 authorizes the Secretary or his delegate to enter into a written agreement relating to a taxpayer's liability for any internal revenue tax for any taxable period. Such an agreement is a final and conclusive determination of the taxpayer's liability with respect to all matters covered by the agreement. The exclusive method of finally closing a taxable year by agreement is to meet all of the statutory requirements of section 7121. Botany Worsted Mills v. United States, 278 U.S.

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[14] Shortly before trial, petitioners filed a motion for leave to file an amended petition, raising theories of equitable estoppel and violation of the requirements of section 7605. That motion was denied; nevertheless, petitioners argued those theories on brief. We shall not consider issues not timely raised. See Rule 34(a).

282 (1929). Section 7121 envisages an agreement knowingly entered into by both the taxpayer and respondent. Estate of Meyer v. Commissioner, 58 T.C. 69, 71 (1972).

Section 301.7121-1(d)(1), Proced. & Admin. Regs., provides that all closing agreements shall be executed on forms prescribed by the Internal Revenue Service. The prescribed forms are Form 866, "Agreement as to Final Determination of Tax Liability," and Form 906, "Closing Agreement on Final Determination Covering Specific Matters." Statement of Procedural Rules, 26 C.F.R. Part 601, section 601.202(b). An agreement executed in any other manner is ineffective as a section 7121 closing agreement. Dorl v. Commisioner, 507 F.2d 406 (2d Cir. 1974), affg. a Memorandum Opinion on this Court; Knapp-Monarch Co. v. Commissioner, 139 F.2d 863 (8th Cir. 1944).

Form 1902-E is a form used by respondent's office auditors. It is in essence the same as Form 4549 which is used by respondent's field revenue agents. We have held that Form 4549 is not a final closing agreement within the purview of section 7121. See Hudock v. Commissioner, 65 T.C. 351 (1975); Harrington v. Commissioner, 48 T.C. 939 (1967), affd. on another issue 404 F.2d 237 (5th Cir. 1968).[15] We hold here that Form 1902-E is not a final closing agreement.

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[15] See also Person v. Commissioner, T.C. Memo 1985-211.

Form 1902-E is a written report, informing the taxpayer of the office auditor's proposed adjustments. By signing the report, the taxpayer agrees to the adjustments contained therein and consents to an immediate assessment and collection of tax resulting from such adjustments. Form 1902-E does not contain language binding either party to the adjustments in the report, as would a final closing agreement. A taxpayer thus would not be barred (after signing Form 1902-E) from bringing an otherwise valid suit for refund for the same year to which the Form 1902-E relates.

The Form 1902-E signed by petitioner was neither signed by the office auditor, nor by petitioner's spouse with whom he filed a joint return. We do not believe that petitioner, in view of his knowledge and sophistication, truly believed that an office auditor had the authority to close out petitioner's 1977 tax case with absolute finality or that the Form 1902-E which he alone signed rose to the dignity of a final closing agreement within the meaning of section 7121.

Deductibility of Losses from Coal Mining Activities

Section 183 provides that if an activity is not engaged in for profit, expenses attributable to the activity are deductible only to the extent of gross income from the activity.[16] Whether an activity is engaged in for profit is determined by applying the rule for deductibility of trade or business expenses under section 162 or the rules for deductibility under section 212(1) or (2).

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[16] Certain deductions which are allowable without reference to gross income from the activity (e.g., interest and taxes) are not in issue.

It is well settled that in order to constitute the carrying on of a trade or business, the activity must be engaged in with an "actual and honest objective of making a profit." *Dreicer v. Commissioner*, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); *Fuchs v. Commissioner*, 83 T.C. 79 (1984); *Dean v. Commissioner*, 83 T.C. 56 (1984); *Allen v. Commissioner*, 72 T.C. 28 (1979). A profit objective is also necessary in order to deduct expenses under section 212(1) or (2). *Lemmen v. Commissioner*, 77 T.C. 1326 (1981); *Jasionowski v. Commissioner*, 66 T.C. 312 (1976). Although a reasonable expectation of profit is not required, the taxpayer must have the intent and objective of realizing a profit. *Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984). "Profit" in this context means economic profit, independent of tax savings. *Beck v. Commissioner*, 85 T.C. 557 (1985); *Herrick v. Commissioner*, 85 T.C. 237 (1985); *Surloff v. Commissioner*, 81 T.C. 210 (1983).

The issue of whether a taxpayer possesses the requisite profit motive is one of fact to be resolved on the basis of all the evidence in the case. *Sutton v. Commissioner*, 84 T.C. 210 (1985), affd. 788 F.2d 695 (11th Cir. 1986); *Fox v. Commisioner*, 80 T.C. 972 (1983), affd. without published opinion 742 F.2d 1441

(2d Cir. 1984), affd. without published opinion sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984); Dunn v. Commissioner, 70 T.C. 715 (1978), affd. 615 F.2d 578 (2d Cir. 1980). In making this determination, more weight must be given to the objective facts than to the taxpayer's mere after-the-fact statements of intent. Thomas v. Commissioner, 84 T.C. 1244 (1985), affd. 792 F.2d 1256 (4th Cir. 1986); Engdahl v. Commissioner, 72 T.C. 659 (1979). Petitioner bears the burden of proving that he possessed the required profit objective. Rule 142(a); Dreicer v. Commissioner, 78 T.C. 642 (1982); Golanty v. Commissioner, 72 T.C. 411 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981).

Section 1.183-2(b), Income Tax Regs., sets forth a nonexclusive list of some relevant factors to be considered in determining whether an activity is engaged in for profit. They are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) any elements indicating personal pleasure or recreation. No one factor is conclusive in making the determination. Allen v. Commissioner, 72 T.C. 28 (1979).

Where a partnership activity is involved, it is the intent of the partnership, rather than that of an individual partner, that is relevant for purposes of section 183. Brannen v. Commissioner, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984); Hager v. Commissioner, 76 T.C. 759 (1981); Surloff v. Commissioner, 81 T.C. 210 (1983). Because a limited partner lacks control over partnership activities, his contention that he had a bona fide profit motive is not of great significance. Dean v. Commissioner, 83 T.C. 56 (1984). The intent of the general partner or, in the case of a tax shelter, the promoter, is more relevant because these individuals actually control the partnership's activities. Fuchs v. Commissioner, 83 T.C. 79 (1984).

After thoroughly considering the entire record, we are convinced that both CHA and North Fork were structured primarily, if not solely, to generate substantial tax benefits and that neither partnership was formed with an objective of entering into coal mining activities for profit. Thus, pursuant to section 183, the expenses incurred by the partnerships in connection with their coal mining activities are deductible only to the extent of income therefrom. As there was no income realized by either CHA or North Fork in 1977, the claimed deductions for petitioner's distributive share of the partnership losses were properly disallowed entirely.

Richard Kaplan, CHA's general partner, had no prior coal mining experience; Barry Wasserstrom, North Fork's general partner, had minimal prior experience. Neither partnership obtained mining permits and neither mined coal on their respective property sites. The mining royalties appear excessively high as do the management fees to the general partners, whereas the working capital for each partnership was extremely low. In order to generate profits, each partnership would have had to mine substantially all of the estimated recoverable coal, and petitioner's estimation of the amount of recoverable coal appears exaggerated.

Even if the partnerships had entered into their mining activities for profit, the advanced royalty payments still would not be deductible. Section 1.612-3(b)(3), Income Tax Regs., as amended in December, 1977, retroactively to October 29, 1976, provides:

> (3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision,

> the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. * * * [Emphasis added.]

On several occasions we have analyzed transactions that are not materially distinguishable from those involved herein. In each of those occasions, we denied a deduction for advanced royalty payments, which were evidenced by a promissory note payable or recoupable out of mining receipts. Vastola v. Commissioner, 84 T.C. 969 (1985); Maddrix v. Commissioner, 83 T.C. 613 (1984), affd. 780 F.2d 946 (11th Cir. 1986); Wing v. Commissioner, 81 T.C. 17 (1983).

The validity of regulation section 1.612-3(b)(3), as amended, has been upheld by this Court, as well as by two Courts of Appeal. Oneal v. Commissioner, 84 T.C. 1235 (1985); Wing v. Commissioner, 81 T.C. 17 (1983); Wendland v. Commissioner, 79 T.C. 355 (1982), affd. per curiam 739 F.2d 580 (11th Cir. 1984), affd. sub nom. Redhouse v. Commissioner, 728 F.2d 1249 (9th Cir. 1984).

Negligence Penalty

The final issue for decision is whether petitioner is liable for additions to the tax pursuant to section 6653(a). Section 6653(a) applies where the underpayment is due to negligence or intentional disregard of the rules and regulations. Petitioner bears the burden that the determination of the negligence addition is erroneous. Rule 142.

Petitioner has failed to persuade us that respondent's imposition of such addition was unwarranted. Based on his knowledge of the tax law, petitioner knew, or should have known, that the claimed deductions for partnership losses were not allowable. Accordingly, we sustain respondent's determination with respect to the addition to tax pursuant to section 6653(a).

To reflect the foregoing,

Decision will be
entered under Rule 155.

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UNITED STATES TAX COURT

ALBAN E. WOOLLEY, JR., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4302-82. Filed September 4, 1986.

Alban E. Woolley, Jr., pro se.

Thomas E. Crowe, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: Respondent determined deficiencies in petitioner's 1978 and 1979 Federal income taxes in the amounts of $2,940 and $5,161.68, respectively.

After concessions, the issues for decision are: (1) whether petitioner is entitled to dependency exemptions for his three children during each year in issue; (2) whether petitioner is

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entitled to deduct casualty losses of $7,000 in 1978 and $7,000 in 1979; and (3) whether petitioner is entitled to deduct travel and entertainment expenses as claimed in 1978 and 1979.[1]

Some of the facts have been stipulated; this reference incorporates herein the stipulation of facts and attached exhibits. Petitioner resided in Cherry Hill, New Jersey, during both years in issue (1978 and 1979), as well as the date on which the petition was filed.

Issue 1. Dependency Exemptions

FINDINGS OF FACT

Petitioner is the father of three children from his previous marriage to Dorothy Woolley (now Dorothy Riley).[2] Pursuant to the terms of their 1977 divorce decree, Dorothy was given custody of the three children, and petitioner was ordered to pay $1,300 per year per child in child support.

During both years in issue, petitioner and Dorothy together provided over half of each child's support. The children resided with Dorothy in New York during both years in issue; petitioner would occasionally visit the children.

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[1] The amount of petitioner's deductible medical expenses will depend on the resolution of these issues.

[2] Amy, born August 31, 1966
Alban Edward III, born August 22, 1969
Daniel, born March 11, 1975

Petitioner claimed dependency exemptions for each of the three children for both 1978 and 1979. Respondent disallowed the exemptions on the bases that: (a) petitioner, as the noncustodial parent, did not provide $1,200 or more for the support of each child in each year, and (b) Dorothy, as the custodial parent, provided more for the support of each child during 1978 and 1979 than did petitioner.

OPINION

A parent is allowed a dependency exemption for each child for whom the parent provides over half the yearly support. Sections 151(e) and 152.[3] Where a child's divorced parents together furnish over half of his support, and the child is in the custody of one or both of his parents for more than half of the year, the child is generally treated as having received over half of his support from the custodial parent. However, if the noncustodial parent provides $1,200 or more for the child's support, and the custodial parent does not clearly establish that she provided more for the support of the child than did the noncustodial parent, the child will be treated as having received more than half of his support from the noncustodial parent. Section 152(e).

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[3] All statutory references are to the Internal Revenue Code of 1954, as amended and as in effect during 1978 and 1979. All Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner testified that he complied with the terms of his divorce decree which required him to pay $1,300 for the support of each of his children ($3,900 in total) for each year in issue. He submitted no corroborating evidence (such as cancelled checks) that he had made these payments. He did, however, submit cancelled checks which reflected expenses he incurred while travelling from New Jersey to New York to visit his children, and he contends that these amounts should be included in calculating his support payments.

Dorothy testified that petitioner did not make all the required child support payments in 1978 and 1979, but rather paid approximately $3,000 in child support in 1979 ($1,000 per child), and somewhat less than $3,000 in 1978. Dorothy submitted expense summaries for 1978 and 1979 which showed that she spent $3,409 to support each child in 1978 and $3,059 for each child in 1979. In addition, she testified that she spent at least $520 in cash per year per child.

Based on the testimony of Dorothy, whom we found to be a credible witness, we believe that petitioner did not provide $1,200 or more for any of the children's support in either 1978 or 1979. The expenses incurred by petitioner in exercising his visitation rights do not constitute child support for purposes of section 152. Hopkins v. Commissioner, 55 T.C. 538 (1970).[4]

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[4] See also Penny v. Commissioner, T.C. Memo. 1985-590.

Petitioner produced cancelled checks which reflected the visitation expenses but he produced none with respect to his payments pursuant to the divorce decree. Had he made the requisite amount of child support payments pursuant to the divorce decree, we believe he would have had the cancelled checks for those payments. Moreover, Dorothy clearly established that she paid more for the support of each child than did petitioner for both years in question. Therefore, petitioner is not entitled to the claimed dependency exemptions in either 1978 or 1979.

Issue 2. Casualty Loss Deduction

FINDINGS OF FACT

Petitioner is in the business of photographing, collecting photographs, and editing photography magazines. He stored photographic equipment, files, photographs and chemicals used in his business in the basement of his home. In 1977, these items were damaged when petitioner's hot water heater burst and flooded his basement.

No independent appraisal of the damage was made. Petitioner had, in prior years, deducted the cost of these items as current trade or business expenses. Petitioner was not compensated for this loss by insurance or otherwise.

Petitioner deducted $7,000 in both 1978 and 1979 as casualty losses due to the bursting hot water heater.[5] Respondent contends that petitioner had no basis in the items damaged by the burst hot water heater and thus disallowed the casualty loss.

OPINION

Section 165(c)(3) allows an individual to deduct a casualty loss.[6] The amount of the deduction is the lesser of: (a) the taxpayer's adjusted basis in the property, as determined under section 1.1011-1, Income Tax Regs., or (b) the decline in the property's fair market value. Section 1.165-7(b)(1), Income Tax Regs. Where a taxpayer deducts the cost of property as a current expense, his adjusted basis in the property is zero; he may not thereafter obtain a casualty loss deduction for the same property. Section 1.1016-2(a), Income Tax Regs. See also section 1.161-1, Income Tax Regs.[7]

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[5] Petitioner apparently had a net operating loss after taking the casualty loss into account in 1977, the year the hot water heater burst; he carried his loss over to 1978 and 1979, and claimed the loss as an itemized deduction (Schedule A), rather than as a loss from his business (Schedule C).

[6] Respondent does not dispute that petitioner's loss resulted from a casualty within the meaning of section 165(c)(3) nor that he properly deducted in previous years the cost of the damaged items.

[7] See also Greenway v. Commissioner, T.C. Memo. 1980-97.

Petitioner admitted that he had deducted the cost of the equipment, film and chemicals prior to their destruction. He failed to demonstrate that he had basis in any of the damaged property. As he had no tax basis, he is not entitled to the claimed casualty loss deduction for either 1978 or 1979.

Issue 3. Travel and Entertainment

FINDINGS OF FACT

Petitioner deducted as travel and entertainment expenses $6,624.42 in 1978 and $6,830.85 in 1979. Respondent disallowed deductions for these expenses asserting inadequate substantiation as required under section 274.

OPINION

Section 274(d) provides that travel and entertainment expenses, in order to be deductible, must be substantiated by adequate records or by sufficient evidence corroborating the taxpayer's own statement. The taxpayer must substantiate (a) the amount of the claimed expense, (b) the time and place of the travel or entertainment, (c) the business purpose of the expense, and (d) the business relationship to the taxpayer of the persons entertained.

In order to substantiate his claimed travel and entertainment deductions, petitioner submitted numerous cancelled checks and receipts for various expenses incurred in 1978 and 1979. These documents, however, did not establish that the expenses were either incurred for a business purpose or involved a business relationship with another person. Petitioner did not submit any other evidence or records in support of his claim, except his own testimony, which we found unpersuasive. Accordingly, we hold petitioner failed to meet his burden of proof, and thus sustain respondent with respect to this issue. Rule 142(a).

To reflect concessions by the parties,

Decision will be entered
under Rule 155.